# SUPREME COURT OF THE UNITED STATES

## OCTOBER TERM, 1926

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## No. 394

## C. G. LEWELLYN, COLLECTOR OF INTERNAL REVENUE FOR THE TWENTY-THIRD DISTRICT OF THE UNITED STATES, ETC., PETITIONER

VS.

## ELECTRIC REDUCTION COMPANY

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ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT

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[Captions omitted.]

In United States District Court for the Western District of Pennsylvania

ELECTRIC REDUCTION COMPANY, A CORPORATION organized and existing under the laws of the State of Delaware,
v.
C. G. LEWELLYN, COLLECTOR OF INTERNAL Revenue for the Twenty-third District of the United States in the Western District of Pennsylvania. } No. 3114 Law

S. Leo Ruslander and George K. Warn, for Plaintiff.
Walter Lyon and Warren H. Van Kirk, for Defendant.

*Docket entries*

Aug. 5, 1924. *Praecipe* for summons in assumpsit and statement of claim filed.

Aug. 5, 1924. Summons in assumpsit issued ret'ble 1st Mon. of Sept. next.

Aug. 6, 1924. Summons returned served with plaintiff's statement of claim on C. G. Lewellyn, by handing to and leaving a true and attested copy thereof with C. G. Lewellyn at Pittsburgh, Aug. 5, 1924.

Aug. 20, 1924. *Praecipe* for appearance of Walter Lyon and Warren H. Van Kirk for deft, filed.

Sept. 12, 1924. Affidavit of defense raising questions of law, filed & entered.

Mar. 23, 1925. Affidavit of defense filed; deft.'s requests for conclusions of lawful. (Jurat.)

Mar. 13, 1925. Order indorsed on argument list: " 1925, Mch. 13. Affidavit of defense raising questions of law withdrawn by consent of parties in open court with leave to file an affidavit of defense as to the merits and in the meantime the case to proceed to trial forthwith without a jury as tho an affidavit of defense had been filed. Same tried. Trial begun and concluded, C. A. V. Schoonmaker, J."

Mar. 13, 1925. Plaintiff's request for findings of fact and conclusions of law filed.

Mar. 25, 1925. Notes and transcript of testimony filed.

July 9, 1925. Opinion filed and entered directing judgment for defendant & noting exception to plaintiff.

July 9, 1925. Pursuant to the foregoing action of the court, judgment is hereby entered in favor of the defendant. J. Wood Clark, clerk.

Sept. 1, 1925. Petition of plaintiff for writ of error and order allowing same filed and entered.

Sept. 11, 1925. Petition & order filed and entered granting leave to file assignment of errors, *nunc pro tunc.*

7 Sept. 10, 1925. Assignment of errors filed.

Sept. 12, 1925. Bond *sur* writ of error approved & filed.

Sept. 12, 1925. Writ of error issued & Copy lodged in clerk's office.

Sept. 12, 1925. Citation awarded & issued and service accepted by Arnold M. Replogle, Ass't U. S. Atty.

Sept. 14, 1925. *Praecipe re* contents of record *sur* writ of error filed.

Sept. 14, 1925. Bill of exceptions, signed & sealed by the court.

[Praecipe for summons, Aug. 5, 1924, omitted in printing.]

5 In United States District Court

*Statement of claim, filed Aug. 5, 1924.*

The Electric Reduction Company, plaintiff above named, complains of C. G. Lewellyn, former collector of internal revenue for the twenty-third district of the United States in the Commonwealth of Pennsylvania, defendant above named, and says that said defendant is justly and legally indebted to plaintiff in the sum of $7,051.55, with interest upon $867.22 thereof from March 15, 1919, and upon $2,092.51 from June 15, 1919, and upon $2,045.91 from September 15, 1919, and upon $2,045.91 from December 15, 1919, upon a cause of action whereof the following is a statement:

1. The Electric Reduction Company, the above plaintiff, is a corporation duly organized under the laws of the State of Delaware. Its office and principal place of business is in Pittsburgh, Pennsylvania.

2. At the time of the payment of the tax as hereinafter set forth, C. G. Lewellyn, the above-named defendant, was collector of internal revenue for the United States of America for the twenty-third district in the Commonwealth of Pennsylvania, having been duly appointed and commissioned some time during the year 1913, and having served in this capacity as a duly qualified officer as aforesaid until about August 1, 1921, when he was succeeded by D. B. Heiner, Esquire.

3. The Electric Reduction Company, in compliance with the act of Congress of February 24, 1919 (known as the revenue act of 1918), duly filed its income and profits tax return for the year 1918, which return showed a tax liability of $8,183.63. Said tax was as

6 shown by true and correct copies of cancelled checks hereto attached, made part hereof, and marked "Exhibits 1, 2, 3, and 4," duly paid to C. G. Lewellyn, defendant, who was internal revenue collector at the times of said payments, as aforesaid, the said four payments totalling $8,184.33, or an overpayment of $.70.

4. Thereafter the Electric Reduction Company, on November 28, 1922, filed an amended income and profits tax return for the year

1918, said return showing a total tax liability for said year in the sum of $1,132.78. With said amended return the Electric Reduction Company filed a claim for refund in the sum of $7,050.85, being the difference between the tax liability shown on the amended return for 1918 and the tax liability shown on the original return for 1918, which was paid. A true and correct copy of said claim for refund, with said amended return as part thereof, is hereto attached, made part hereof, and marked "Exhibit 5."

5. The said amended return and said claim for refund were filed for the reason that the Electric Reduction Company suffered a deductible loss of $27,205.35 in 1918, which by error and mistake was not deducted as a loss for said year 1918 in the original return filed. The said loss occurred by reason of the facts as hereinafter set forth.

6. By writing dated July 2, 1918, and accepted July 3, 1918, the Electric Reduction Company entered into a contract with Konstantine Jouravleff, by which contract the said Konstantine Jouravleff agreed to deliver to said Electric Reduction Company one hundred fifty tons of tungsten ore sheelite to run over sixty per cent W. O. 3, deliveries to be made to said company's factory at Washington, Pennsylvania, in shipments of one car of thirty to thirty-five tons each month beginning August, 1918, through to the end of that
7 year; payments $24.00 per unit of one per cent of W. O. 3, the ton to be two thousand pounds. It was further agreed that the Electric Reduction Company should accept a draft for $30,000.00 in favor of said Jouravleff, payable in sixty days, to cover and to be deducted from the amount due from said company to said Konstantine Jouravleff of W. O. 3, which was to be shipped by said Jouravleff to said company in August, as aforesaid, and which would have a value of more than $30,000.00, and a like acceptance issued, if necessary, on the following cars. A true and correct copy of said contract is hereto annexed, made part hereof, and marked "Exhibit 6."

7. The said contract was negotiated through one Charles Hardy who acted as broker in the transaction. Prior to the making of said contract the said Konstantine Jouravleff was unknown to the plaintiff and plaintiff had had no previous business relations with him and he was brought to the attention of said company by the said Charles Hardy, who, to induce the plaintiff to enter into the said contract, falsely represented that said Jouravleff was a reputable business man of unquestioned integrity and financial responsibility and in a position to deliver tungsten ore in accordance with the said contract, and that he would vouch for him.

8. At the time of making said contract (Exhibit 6) and in order to induce the Electric Reduction Company to agree to the terms thereof and to give the acceptance provided for in said contract, the said Charles Hardy, in order to consummate the deal, at the request of the said company, undertook to keep said company fully informed concerning the deliveries of tungsten ore to be made by said Jouravleff under said agreement, which deliveries were to be made at a point distant from said company's place of business and

8 plant, and also concerning the progress said Jouravleff was making in mining and concentrating said tunsgten ore to be used in the fulfilling and performance of said contract, and to following up and seeing to the deliveries of tungsten ore by said Jouravleff.

9. After making said contract for delivery of tungsten ore and the making of said acceptance, the Electric Reduction Company performed the same on its part to be performed, and executed and delivered to said Jouravleff the acceptance referred to for $30,000.00. A true and correct copy of said acceptance is hereto annexed, made part hereof, and marked " Exhibit 7."

10. The said acceptance was given to the said Jouravleff on his written agreement that it was to cover and be deducted from the price of the first car of tungsten ore shipped, which car was to be shipped before the maturity of the trade acceptance on the 30th day of August, 1918, and with the understanding that the same was for material to be delivered by said Jouravleff to the plaintiff; and that if the said car was not shipped and delivered as agreed, the plaintiff was at liberty to refuse to pay said trade acceptance.

11. The said Charles Hardy had full knowledge of the terms and conditions under which said trade acceptance was given as hereinabove set forth.

12. John MacGregor Grant, Inc., was, at the time of the matters herein set forth, a corporation organized under the laws of the State of New York, engaged in the brokerage and banking business, had its principal place of business in New York City, and was a backer and promoter of the enterprise in which said Jouravleff was engaged.

9 13. The said John MacGregor Grant, Inc., had full knowledge of the agreement between the Electric Reduction Company and said Jouravleff, knew the conditions under which said acceptance was made, knew that the said Jouravleff failed to perform his contract and failed to deliver any tungsten ore, as required therein, and had not on August 30, 1918, delivered or shipped, or was in a position to deliver or ship, any car of tungsten ore, as required by said contract.

14. By mistake of the officers of the Electric Reduction Company, and contrary to the agreement as to the making thereof, the said acceptance (Exhibit 7) was made negotiable, and unconditional, instead of conditional with notice of its terms on its face.

15. The said John MacGregor Grant, Inc., with full knowledge of the facts, as before stated, and with full knowledge of the fact that the said Konstantine Jouravleff had not shipped or delivered, and was not able to ship or deliver any car of tungsten ore, as required by said contract (Exhibit 6), negotiated for the said Konstantine Jouravleff the said acceptance to other persons, without notice, from whom the said John MacGregor Grant, Inc., received the sum of $30,000.00.

16. The Electric Reduction Company thereafter and upon maturity, on August 30, 1918, duly paid the said acceptance to the holder thereof.

17. Subsequent to the making of said contract (Exhibit 6) and before the maturity of said acceptance (Exhibit 7), the Electric Reduction Company, from time to time, inquired of the said Charles Hardy concerning the progress that the said Konstantine Jouravleff was making in mining the said tungsten ore to be made by the said Jouravleff for said company under said contract, and the said
10 Charles Hardy, pursuant to the agreement which he had made with said company and the duties assumed by him in respect to said inquiries, promised to investigate said matters and to report thereon to said company.

18. The Electric Reduction Company was induced to pay said acceptance by receipt of a telegram from said Charles Hardy, and in reliance thereon. Said telegram is as follows:

AUGUST 29, 1918.

ELECTRIC REDUCTION COMPANY,
*Washington, Pa.*

Reference contract Jouravleff. Shipment, one car will be made today.

HARDY.

The information given in said telegram was false.

19. No part of the contract was ever carried out by the said Konstantine Jouravleff, except in December, 1918, the said Electric Reduction Company received from the said Jouravleff 56 bags containing 4,468.24 pounds of sheelite concentrates, in value amounting to $2,794.65, which sum was to be credited to the amount of $30,000.00, making a net loss of $27,205.35.

20. The Electric Reduction Company, from time to time, made efforts to obtain shipments of tungsten ore under the terms of said contract (Exhibit 6), or to obtain repayment of the said sum of $30,000.00, but no shipments were made thereon except 4,468.24 pounds in December, 1918, of a value of $2,794.65, which was applied on said acceptance, and left the loss thereon of $27,205.35.

21. On October 30, 1918, the Electric Reduction Company learned that the said Konstantine Jouravleff had never been and
11 would not be in a position to perform under his said contract; that the mining proposition by which the said Konstantine Jouravleff was to fulfill his contract with said company was that conducted by the Pine Creek Tungsten Company, in which the said Jouravleff had only a stock interest, but was not in control of said company nor of any of its property; that the mill and mines of said Pine Creek Tungsten Company were located near Bishop, Inyo County, California, and were in the development stage; the Electric Reduction Company later learned that the mines and mill of said Pine Creek Tungsten Company were in a development stage until in De-

cember, 1918; that said mill was not completed nor put into operation until in December, 1918, at which time from fourteen to sixteen tons of concentrates were produced by it and turned over to the Inyo County Bank, of Bishop, California, as security for money loaned by said bank; there was no other production of tungsten ore by said Pine Creek Tungsten Company in 1918.

22. Efforts were made by the Electric Reduction Company to recover its loss under said contract by bringing in March, 1919, three suits in the Supreme Court of the County of New York, State of New York; one against Konstantine Jouravleff; one against John MacGregor Grant, Inc., and one against Charles Hardy, the broker. Judgment was obtained against the said Konstantine Jouravleff, in 1919, in said suit against him. The judgment proved worthless as the said Jouravleff had no assets and disappeared. In 1921 the said suit against John MacGregor Grant, Inc., was discontinued as worthless as the defendant in that action had been adjudged bankrupt after the commencement of the suit. In the suit against Charles Hardy, the trial court on November 23, 1922, directed a verdict in favor of the defendant.

12 23. The Electric Reduction Company, by letter from the Commissioner of Internal Revenue, dated November 29, 1922, file reference IT:SA:AM:EG:264, was notified of a proposed additional assessment of income and profits taxes against it for the year 1918 in the sum of $3,774.51. A true and correct copy of said letter is hereto attached, made part hereof, and marked "Exhibit 8."

24. The Electric Reduction Company, by letter from the Commissioner of Internal Revenue, dated January 2, 1923, file number IT:SA:AM:EG:264, was advised that its claim for refund of $7,050.85 (Exhibit 5) was rejected. A true and correct copy of said letter is hereto attached, made part hereof, and marked "Exhibit 9."

25. The Electric Reduction Company, following the receipt of said letters (Exhibits 8 and 9) and within the time provided therefor, protested against the said proposed additional assessment of $3,774.51 and the rejection of its claim for refund of $7,050.85, and hearings were duly had thereon before the Income Tax Unit as provided by statute and Treasury Regulations.

26. Subsequent to said hearings, by letter from the Commissioner of Internal Revenue, dated March 13, 1923, the Electric Reduction Company was advised that its income, war, and excess profits taxes for the year 1918 were adjusted and its case closed on the basis of additional tax of $3,744.51. A true and correct copy of said letter is hereto attached, made part hereof, and marked "Exhibit 10."

27. Within the time provided by the revenue act and in accordance therewith and with the Treasury Regulations applying, the Electric Reduction Company duly appealed to the committee on ap-

13 peals and review, the body appointed by the Commissioner of Internal Revenue to hear and adjudge such cases, from the assessment of said additional tax of $3,774.51, and from the rejec-

tion of its claim for refund. A hearing was duly had thereon before said committee, and subsequently the Electric Reduction Company received a letter from the Treasury Department of the United States, dated April 17, 1923, file number IT:SA:AM:EG:264, rejecting its claim on said appeal and sustaining the Income Tax Unit in its conclusions. A true and correct copy of said letter is hereto attached, made part hereof, and marked "Exhibit 11."

28. Thereafter, on February 15, 1924, the Electric Reduction Company duly filed its claim for refund of said sums of $3,840.56 and $7,050.85, plus said overpayment of $.70, or a total of $10,892.11, taxes excessively and illegally demanded and collected. A true and correct copy of said claim for refund is hereto annexed, made part hereof, and marked "Exhibit 12."

29. By letter from the Commissioner of Internal Revenue dated August 1, 1924, file number IT:CR:C:CA, the Electric Reduction Company was advised that its said claim for refund was refused. A true and correct copy thereof is hereto attached, made part hereof, and marked "Exhibit 13."

30. The said acceptance (Exhibit 7) was made and delivered upon the strength of, and in reliance upon, the representations of the said Charles Hardy that the said Konstantine Jouravleff personally was in a position to and would deliver to said company before the maturity of said acceptance tungsten ore in such quantity to have a value in excess of the face of said acceptance, and the amount of said acceptance should be credited against said delivery, and
14 that the said Konstantine Jouravleff was in a position to and would otherwise fully perform under said contract, as set forth in paragraphs 7 and 8 hereof, whereas, in fact and in truth the said Konstantine Jouravleff was in a no position to ship the said tungsten ore in August, 1918, before the maturity of said acceptance, or at any other time; that the said Konstantine Jouravleff was not then or later the owner of any mines of tungsten, or otherwise, was not in a position to and did not control the output of any such mines, the mines of the Pine Creek Tungsten Company were not at any time in 1918 in a position to ship tungsten ore in quantities called for by said contract, all of which was well known to the said Konstantine Jouravleff, Charles Hardy, and John MacGregor Grant, Inc. That at all times during the year 1918 and thereafter said Jouravleff was financially irresponsible and a judgment recovered against him would have been uncollectible.

31. The said acceptance was negotiated by the said John MacGregor Grant, Inc., to innocent holders for value and with full knowledge of its conditional character and with full knowledge of Konstantine Jouravleff's being unable to perform said contract (as set forth in paragraphs 15 and 30 hereof); and said acceptance was duly paid at maturity through the false representations of the said Charles Hardy and in reliance thereon (as set forth in paragraph 18 hereof); with a resulting loss of $27,205.35, as stated in paragraph

20 above; the entire loss of $27,205.35 occurred in 1918, and resulted by reason of the giving, negotiating and paying said acceptance under the false representations of the said Charles Hardy and John MacGregor Grant, Inc., as hereinabove set forth. That during the year 1918 said John MacGregor Grant, Inc., was financially ir-
15 responsible and a judgment against it could not have been collected. That in 1918 the plaintiff had no legally enforceable claim against said Hardy as subsequently established by the suit entered. The defense of said Hardy was, specially, that the said allegel agreement between this plaintiff and the said Hardy constituted a special promise by said Hardy to answer for the debt, default, or miscarriage of another person, to wit, Konstantine Jouravleff; that said promise was not nor any note or memorandum thereof made in writing and subscribed by the said Hardy or by his lawful agent, and was void under the Statutes of Frauds.

32. The Electric Reduction Company is informed and believes, and therefore avers, that under the internal-revenue laws and Treasury Regulations said loss was a proper and lawful deduction against the income of said company for the year 1918, and that the collection of said amount of $7,051.55 as income and profits taxes due by the Electric Reduction Company for the year 1918, and being the excess of the amount shown by said amended return as being the tax due by said company for said year, was illegal.

33. The Electric Reduction Company is advised and believes, and therefore avers, that there existed no warrant in law for the collection, by the then said Commissioner of Internal Revenue, of the sum of $7,051.55 as corporation income and profits taxes due by the said company for the period ended December 31, 1918, herein complained of, under the provisions of the act of Congress of February 2, 1919; and that there existed no warrant in law for the refusal by the said Commissioner of Internal Revenue to refund said sum of $7,051.55, being the excess payment of tax made as aforesaid, in 1919.

16 34. That the collection by the then collector of internal revenue of the said sum of $7,051.55, being the excess of income tax lawfully due by the plaintiff for 1918, was unlawful and void, and without authority of law; and that there is therefore due from the defendant to the plaintiff the amount thereof, to wit, $7,051.55, with interest as aforesaid, for the recovery of which plaintiff brings this, its suit. That the amount sought to be recovered in this case is not the full $10,892.11 illegally collected because said sum was not all paid to defendant. A separate suit is being entered for the remaining $3,840.56.

S. Leo Ruslander,
Geo. K. Warn,
*Attorneys for Plaintiff.*

*Duly sworn to by J. W. Weitzenkorn; jurat omitted in printing.*

17 In United States District Court

*Affidavit of C. G. Lewellyn, filed March 23, 1925*

STATE OF PENNSYLVANIA,
*County of Allegheny, ss:*

C. G. Lewellyn, being duly sworn according to law, declares and says that he is the defendant in the above-entitled cause and that he has a just, true, complete, and legal defense to the whole of the plaintiff's claim of the character and nature as follows:

I

The averments of paragraph one of plaintiff's statement are admitted.

II

The averments of paragraph two of plaintiff's statement are admitted.

III

The averments of paragraph three of plaintiff's statement are admitted.

IV

The averments of paragraph four of plaintiff's statement are admitted.

V

With respect to the averments of paragraph five, the defendant admits that plaintiff filed an amended return and claim for refund for the reason that plaintiff claimed to have suffered a deductible loss of $27,205.35 in 1918, but defendant denies that plaintiff suffered a deductible loss of $27,205.35 during the year 1918, and denies that plaintiff committed either error or mistake in not claiming said amount as a deductible loss for said year 1918 in plaintiff's original return.

18

VI

The averments of paragraph six of plaintiff's statement are admitted.

VII

The averments of paragraph seven of plaintiff's statement are admitted.

VIII

The averments of paragraph eight of plaintiff's statement are admitted.

plaintiff filed its claim for refund in the amounts stated; but defendant denies that said taxes were excessively and illegally demanded and collected.

XXIX

The averments of paragraph twenty-nine of plaintiff's statement are admitted.

22

XXX

The averments of paragraph thirty of plaintiff's statement are admitted in so far as it is therein alleged that said acceptance was made and delivered by plaintiff upon the strength of, and in reliance upon, the representations of the said Charles Hardy, that the said Konstantine Jouravleff personally was in a position to and would deliver to said company before the maturity of said acceptance the tungsten ore in such quantity as to have a value in excess of the face of said acceptance, and that the amount of said acceptance would be charged against said delivery, and that the said Jouravleff was in a position to and would otherwise fully perform said contract. In so far as said paragraph 30 avers that the said Konstantine Jouravleff was in no position to ship the said tungsten ore in August, 1918, or at any other time; that the said Konstantine Jouravleff was not then or later the owner of any mine, of tungsten, or otherwise, was not in a position to and did not control the output of any such mines; the mines of the Pine Creek Tungsten Company, were not at any time in 1918 in a position to ship the tungsten ore in quantities called for by said contract, all of which was well known to the said Jouravleff, Charles Hardy, and John MacGregor Grant, Inc., and that at all times during the year 1918, and thereafter, said Jouravleff was financially irresponsible and that a judgment recovered against him would have been uncollectible, the same is denied.

XXXI

The averments of paragraph thirty-one of plaintiff's statement are admitted in so far as it is therein alleged that the said acceptance was negotiated by John MacGregor Grant, Inc., and
23 paid at maturity, and that Charles Hardy made false representations as set forth in paragraph eighteen of plaintiff's statement; and said paragraph is also admitted in so far as it is therein alleged that the said Charles Hardy set up the defense of the statute of frauds in the suit which was instituted by plaintiff against the Charles Hardy, and that the plaintiff did not recover a judgment against the said Hardy. The averments of paragraph thirty in so far as it is therein alleged that the said acceptance was negotiated to innocent holders for value and that the plaintiff suffered a loss of $27,205.35 in the year 1918 as a result of giving, negotiating, and paying said acceptance; and also in so far as it

is therein alleged that the said John MacGregor Grant, Inc., was financially irresponsible, and that a judgment against it in the year 1918 could not have been collected, are denied.

XXXII

The averments of paragraph thirty-two of plaintiff's statement are denied.

XXXIII

The averments of paragraph thirty-three of plaintiff's statement are denied.

XXXIV

The averments of paragraph thirty-four of plaintiff's statement in so far as it is therein alleged that the collection by the then collector of internal revenue of the sum of $7,051.55, for 1918, was unlawful and void and without authority of law, and that there is due the plaintiff the amount thereof, to wit, $7,051.55, with interest thereon, are denied. The averments of said paragraph thirty-
24 four in so far as it is therein alleged that a separate suit is being entered for $3,840.56, are admitted.

I, therefore, owe the plaintiff nothing.

All of the above stated facts are correct and true and defendant avers and expects upon the trial of this cause to be able to prove the same.

C. G. LEWELLYN.

Subscribed and sworn to before me this 23rd day of March, 1925.
[SEAL.]
A. M. KUSTES.
*Dep. Clk. U. S. D. Court.*

In United States District Court

*Requests for findings of fact and conclusions of law ex parte plaintiff, filed March 13, 1925*

The above entitled case having been tried upon stipulation of counsel that the testimony be heard and the case determined by the court without a jury, both parties waiving their respective rights to trial by a jury, plaintiff makes the following

*Requests for findings of fact*

1. Plaintiff paid out the $27,205.35, which is the basis of the claimed charge off as against 1918 income in the year 1918, and although plaintiff was diligent in seeking to recover said loss, was unsuccessful, and the total amount thus paid in 1918 was never, either in part or in while, recovered by plaintiff.

25 2. Aside from the legal question as to whether the loss was a "bad debt" or other "loss," as defined in the revenue act of 1918, it was sustained by plaintiff in the year 1918.

3. Plaintiff would not have paid the bill of exchange, Exhibit 7 attached to the plaintiff's statement, had it not relied upon misrepresentations of fact as to the shipment of a car of tungsten, the value of which would have been in excess of the $30,000.00 paid.

*Requests for conclusions of law*

1. The loss sustained by plaintiff falls within the provision of section 214-(a)-4 of the revenue act of 1918, which provides, "That in computing net income there shall be allowed as deductions * * * losses sustained during the taxable year * * * if incurred in trade or business."

2. Under all the evidence in this case, the judgment must be rendered in favor of the plaintiff.

Respectfully submitted,

S. LEO RUSLANDER,
*Attorney for Plaintiff.*

26 In United States District Court

*Bill of exceptions, filed Sept. 14, 1925*

Be it remembered that this cause coming on to be heard before Honorable F. P. Schoonmaker, district judge, all parties being represented by counsel, and plaintiff's statement of claim and defendant's affidavit of defence raising questions of law having been filed, the following order was endorsed on the argument list:

*Minute entry*

"1925, Mch. 13. Affidavit of defense raising questions of law withdrawn by consent of the parties in open court with leave to file an affidavit of defense as to the merits and in the meantime the case to proceed to trial forthwith without a jury as though an affidavit of defense had been filed. Same tried. Trial begun and concluded. C. A. V. Schoonmaker, J."

The parties, by their respective counsel, then and there entered into a stipulation of facts which is as follows:

*Stipulation of facts*

And now, to wit, March 13, 1925, it is hereby stipulated and agreed by and between counsel for the above-named parties that the above-entitled case may be considered and finally determined by the court upon the pleadings filed; and in any such determination and disposition the court shall take, as admitted, the following facts, viz:

1. The Electric Reduction Company, plaintiff, claims of C. G. ewellyn, former collector of internal revenue, the defendant, the sum of $7,051.55, with interest upon $867.22 thereof from
7 March 15, 1919, and upon $2,092.41 thereof from June 15, 1919, and upon $2,045.91 thereof from September 15, 1919, and pon $2,045.91 thereof from December 15, 1919, as additional cor- oration income tax which said amounts were paid to the defendant ollector on the respective dates set forth.

2. The Electric Reduction Company, the plaintiff, is a corporation luly organized under the laws of the State of Delaware, with its rincipal place of business in Pittsburgh, Pennsylvania.

3. C. G. Lewellyn, the defendant, at the times of payment of said ax of $7,051.55 was the collector of internal revenue for the twenty- hird district in the Commonwealth of Pennsylvania.

4. The Electric Reduction Company duly filed its income and rofits tax return for the year 1918, which showed a tax liability of $8,183.63, which said tax was duly paid to C. G. Lewellyn, the then ollector of internal revenue.

5. On or about November 29, 1922, the Electric Reduction Com- pany filed an amended income and profits tax return for the year 1918, showing a tax liability for said year of $1,132.78, and claiming a loss sustained for the year 1918 in the sum of $27,205.35 as is more particularly shown hereinafter. With said amended return it filed a claim for refund in the sum of $7,050.85, being the difference between the tax liability shown on the amended return for 1918 and the tax liability shown on the original return for 1918, which was paid. Said claim for refund was rejected by the commissioner by letter dated April 17, 1923, upon the ground that the loss was not finally and definitely determined to be a loss until 1922, and was not charged off as such until 1922.

28 6. The reason alleged by the Electric Reduction Company for the filing of the claim for refund and the amended return was that it claimed to have suffered a deductible loss of $27,205.35 in the year 1918, which was not deducted as a loss for said year 1918 in the original return filed.

7. The transaction on which said claim of loss is based was as follows:

8. The Electric Reduction Company entered into a contract with one Konstantine Jouravleff, dated July 2, 1918, and accepted July 3, 1918. Jouravleff therein agreed to deliver to the Electric Reduction Company one hundred fifty (150) tons of tungsten ore sheelite at said company's factory, Washington, Pennsylvania, in shipments of one car of 30 to 35 tons each month beginning August, 1918, through to the end of that year; payments $24.00 per unit. It is agreed that Exhibit 6 attached to plaintiff's statement is a true and correct copy of said contract. The Electric Reduction Company agreed to and did accept a trade acceptance for $30,000 in favor of said Jouravleff, payable in sixty days, to apply on and to be deducted

from the amount which would be due Jouravleff when he made the first shipment of ore. It is agreed that Exhibit 7 attached to plaintiff's statement is a true and correct copy of said trade acceptance.

9. Prior to the making of said contract Jouravleff was unknown to the Electric Reduction Company; he was introduced by one Charles Hardy, a broker handling ores, who, to induce the plaintiff to enter into the said contract, verbally represented that said Jouravleff was a reputable business man of unquestioned integrity and financial responsibility, and that he was in a position to deliver tungsten ore in accordance with said contract.

10. At the time of making the contract between Jouravleff and the Electric Reduction Company, and in order to induce said company to agree to the terms thereof and to give the acceptance provided for in said contract, the said Charles Hardy, at the request of the said company, verbally undertook to keep the said company fully informed concerning the deliveries of tungsten ore to be made by said Jouravleff under said contract, which deliveries were to be made at a point distant from said company's place of business and its plant, and also concerning the progress said Jouravleff was making in mining and concentrating the said tungsten ore to be used in the fulfilling and performance of said contract, as well as following up and seeing to the deliveries of said tungsten ore by said Jouravleff.

11. After the making of the contract between Jouravleff and the Electric Reduction Company, said company performed the same on its part to be performed, and executed and delivered to said Jouravleff the acceptance provided for in the contract for $30,000.00.

12. The said acceptance was given to Jouravleff with the agreement that it was to cover and be deducted from the price of the first car of tungsten ore to be shipped, which car was to be shipped before the maturity of the trade acceptance on August 30, 1918; and that if said car was not shipped and delivered as agreed, the plaintiff was at liberty to refuse to pay the said trade acceptance.

13. The said Charles Hardy had full knowledge of the terms and conditions under which said trade acceptance was given.

14. John MacGregor Grant, Inc., was, in 1918, a corporation organized under the laws of the State of New York, engaged in the brokerage and banking business, had its principal place of business in New York City, and was a backer and promoter of the enterprise in which Jouravleff was engaged.

15. The said trade acceptance for $30,000 was made negotiable and unconditional, and was placed before maturity with John MacGregor Grant, Inc.

16. John MacGregor Grant, Inc., with full knowledge of the facts, and with full knowledge of the fact that the said Jouravleff had not shipped or delivered, and was not able to ship or deliver any car of tungsten ore, as required by the contract between Jouravleff and the Electric Reduction Company, negotiated for the said Jouravleff the said acceptance to innocent holders, without notice, and received therefor the sum of $30,000.

17. The Electric Reduction Company duly paid the trade acceptance of $30,000 on August 30, 1918, at maturity, to the holder thereof.

18. Subsequent to the making of the contract between Jouravleff and the Electric Reduction Company, and before the maturity of said trade acceptance on August 30, 1918, the Electric Reduction Company, from time to time, inquired of Charles Hardy concerning the progress that the said Jouravleff was making in mining tungsten ore, and the said Hardy promised to investigate and report.

19. The Electric Reduction Company was induced to pay said trade acceptance by receipt of a telegram from Charles Hardy, and in reliance thereon. Said telegram is as follows:

"AUGUST 29, 1918.

ELECTRIC REDUCTION COMPANY,
*Washington, Pa.*

"Reference contract Jouravleff. Shipment one car will be made to-day.

"HARDY."

The information given in said telegram was false. No car was ever shipped.

20. The Electric Reduction Company, from time to time, made efforts to obtain from the said Jouravleff shipments of tungsten ore under the terms of the contract between them, and to obtain repayment of the said sum of $30,000.00, but no part of said contract was ever carried out by the said Jouravleff, except the said company received from Jouravleff in December, 1918, fifty-six (56) bags containing 4,468.24 pounds of sheelite concentrates (tungsten ore) of a value of $2,794.65, which amount the Electric Reduction Company applied on said trade acceptance of $30,000.

21. The Electric Reduction Company in March, 1919, brought three suits in the Supreme Court of the County of New York, State of New York; one against Konstantine Jouravleff; one against John MacGregor Grant, Inc., and one against Charles Hardy, the broker, to recover the said sum of $27,205.35. Judgment was obtained against the said Jouravleff in 1919, in said suit against him. The said judgment proved worthless as the said Jouravleff had no assets and had disappeared. In 1921 the said suit against John MacGregor Grant, Inc., was discontinued as worthless as the defendant in that action had been adjudged bankrupt after the commencement of the suit. In the suit against Charles Hardy the trial court, on November 23, 1922, directed a verdict against the therein plaintiff upon the special defense of Hardy that the alleged agreement between the Electric Reduction Company and him constituted a special promise by Hardy to answer for the debt, default or miscarriage of another person, and that said promise, note, or memorandum was not made in writing or subscribed by Hardy, and was void under the Statute of Frauds.

22. The Electric Reduction Company did not charge off the amount of $27,205.35 as a loss upon said trade acceptance until

[Indorsed on reverse side:] Pay to the order of John MacGregor Grant, Inc. K. Jouravleff.

Pay to the order of Hannevig and Company John MacGregor Grant, Inc. John M. Grant, president. Hannevig and Company, A. Statt, Lex. Hansen.

37 Pay to the order of any bank or trust company. Prior indorsements guaranteed, Jul. 25, 1918, Empire Trust Company, New York, N. Y. Byron L. Brown, secretary.

Pay to the order of any bank or trust company. All prior indorsements guaranteed, Girard National Bank, Phila. 8–13. Chas. M. Ashton, cashier.

$6.00 U. S. documentary stamps canceled.

PLAINTIFF'S EXHIBIT NO. 1

LOS ANGELES, CALIF., *Dec. 18, 1918.*

ELECTRIC REDN. CO.,
*Washn., Pa.*

In good faith I sent you yesterday's telegram and it proved again untrue, because not withstanding a gentleman's agreement the whole thing has been taken out of my hands and placed in full control of a Bishop banker. To-day when I was getting ready to go east they placed before me the alternative of my surrendering the control or closing down the business and time for answer given seven hours. Please send at once your representative to act quickly. I am still holding stock in the company and have a contract for concentrate and claims against other big stockholders. I am placing myself at your full disposal and will cooperate with you in any way and have wired New York placing at your disposal for payment my in-

38 terest in Baltimore tungsten smelting plant. The business here is a good one but is in the hands of unreliable and incompetent men.

JOURAVLEFF.

During the course of said trial the court made certain rulings rejecting evidence offered by the plaintiff and in each instance counsel for plaintiff duly excepted thereto; counsel for defendant offered no testimony; at the conclusion of the trial counsel for plaintiff submitted to the court requests for findings of fact and conclusions of law, no specific answers being given thereto.

*Minute entries*

On March 23, 1925, an affidavit of defense as to the merits was filed.

Thereafter the court on July 9, 1925, filed an opinion in which the clerk was directed to enter judgment for defendant and due exception noted to plaintiff, and on the same day judgment was accordingly so entered.

On September 1, 1925, petition was presented by the plaintiff for a writ of error and citation, and order made the same day allowing same and fixing bond in the sum of $500.00 as security for costs, and assignment of errors filed.

*Assignments of error*

First exception. The learned court erred in rendering and entering judgment for defendant, as contained in the opinion of the court filed July 9, 1925, and the entry made thereon as follows:

"Judgment may be entered in this case in favor of defendant and due exception noted to the plaintiff.

39 "July 9, 1925. Pursuant to the foregoing action of the court, judgment is hereby entered in favor of the defendant."

Second exception. The learned court erred in refusing judgment for the plaintiff against the defendant.

Third exception. The learned court erred in ruling as a matter of law that under the facts as found by the court the plaintiff is not entitled to recover, which ruling is contained in the opinion of the court as follows:

"On this state of facts we find as a matter of law that the plaintiff is not entitled to recover."

Fourth exception. The learned court erred in its opinion in ruling as follows:

"The transaction involved is one of debt falling within the provisions of section 234(a) (5) of the revenue act of 1918, hereinbefore quoted."

Fifth exception. The learned court erred in not ruling, as requested, that the transaction involved resulted in a loss to plaintiff within the provisions of section 234(a) (4) of the revenue act of 1918, which request was as follows:

"The loss sustained by plaintiff falls within the provisions of section 214(a) (4) of the revenue act of 1918, which provides: 'That in computing the net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions:

"'* * * Losses sustained during the taxable year and not compensated for by insurance or otherwise * * * if incurred in trade or business.'"

40 Sixth exception. The learned court erred in holding the loss was by reason of a bad debt as set out in the following portion of its opinion:

"* * * plaintiff lost the money it paid Jouravleff on account of the purchase price of ore, but that loss arose out of a bad debt, which to be claimed as a deduction from income must be charged off during the taxable year. This was not done. The plaintiff cannot recover."

Seventh exception. The learned court erred in rejecting the plaintiff's offer of evidence, as follows:

Plaintiff's witness, William H. Weis, being on the stand, the following offer and ruling occurred (Transcript, pp. 17–19):

Mr. RUSLANDER:

Q. When did the Electric Reduction Company cease to transact business?

A. July 1st, 1920.

Q. Did it at any time after 1918, have sufficient income to absorb the loss on this Jouravleff transaction?

Mr. BLAISDELL. Defendant objects, as being entirely immaterial, incompetent, and irrelevant to any issue in this case. This simply refers to the reduction of loss in 1918.

The COURT. We do not see that this is material.

Mr. RUSLANDER. I will make an offer. Counsel for plaintiff offer to prove by the witness on the stand that unless the loss as alleged is against income in the year 1918, the plaintiff will not have the benefit of it, because it ceased to continue its business and
41 earning an income prior to the termination of the suits in 1922, and its income in 1919, 1920, and 1921 was so small that it would not have absorbed any appreciable amount of the loss. This for the purpose of arguing that under the law and regulations which fix losses as against income, the plaintiff could not have sustained a loss of this character in the years subsequent to 1918, especially after they had ceased to do business.

Mr. BLAISDELL. Defendant objects to the offer, for the reason that it is immaterial, irrelevant, and incompetent, and can not properly affect any issue in this case, the only issue in this case being whether or not a certain item was a proper deduction for the year 1918.

The COURT. In view of the fact that the only issue in this case is whether or not the plaintiff is entitled to claim the item in issue here as a deductible loss in 1918, we can not see that it is at all material to inquire into the incomes of the plaintiff under the years succeeding 1918. That would apparently have no bearing upon the issue in this case. For that reason, we sustain the objection and note an exception to the plaintiff."

Eighth exception. The learned court erred in rejecting the plaintiff's offer of evidence, as follows:

Plaintiff's witness, William H. Weis, being on the stand, the following offer and ruling occurred (Transcript, pp. 21–24):

42 Mr. RUSLANDER:

Q. Is an account receivable a definitely known term in accounting?

A. As I understand the term——

Q. Just answer the question whether or not it is.

A. Yes.

Mr. RUSLANDER. Counsel for plaintiff desires to ask the witness questions as an expert, and before doing so offers the counsel for the defendant the opportunity to cross-examine as to his qualifications.

Mr. BLAISDELL. I do not care to cross-examine the witness as to his competency, but I propose to object to what I think is coming. I would suggest you make an offer.

Mr. RUSLANDER. Counsel for plaintiff offer to prove by the witness as a qualified and experienced accountant, the following: that there is a distinction between the accounting method of handling a loss and carrying an accounts receivable; that an accounts receivable, as it is ordinarily understood, means credit extended to a customer, or money loaned, or an account that arises in the usual course of business in which (credit) extended to the debtor is the determining factor; that advance payments for merchandise, or losses by obtaining merchandise under false pretense or by conspiracy, or other cases of that character where there is no factor as to granting credit to the person who receives the money or merchandise, are not regarded as accounts receivable, but as transactions which represent losses. Further, that the transaction in question being the
43 payment of the money to Jouravleff upon the false representation that the car of ore was already shipped, would not constitute a transaction that should be properly carried as an accounts receivable, but one which should be carried on the books as showing a loss, as distinguished from a purely accounts receivable or bad debt.

Mr. BLAISDELL. To this offer the defendant objects, for the reason that the same is entirely immaterial and incompetent, and can not tend to prove or disprove any issue in this case. The statement of facts herein admitted, supplemented by the testimony of this witness, shows that the item in question, the amount of money, $30,000, was charged to Jouravleff as an advance payment on ore. The statement of facts also shows that it was carried as a bills receivable item upon the books of the plaintiff. In view of these facts, I can not see any relevancy for an expert dissertation upon accounting.

The COURT. Apparently under the statute the taxable is entitled to charge off losses sustained during the taxable year and ascertained to be bad debts. It is impossible for us to see how—whether the accounting profession, expert accountants, regard such transactions as accounts receivable or not—has any bearing upon the issue raised by the statute here. We have to determine, first, whether the loss claimed is a loss which occurred in the fiscal year 1918, or whether it is a bad debt, as described by the statute at that time. Now, what the practice of accountants may be with reference to the book entries of transactions, we think would have no value whatever in
44 arriving at any determination upon the issues here. For that reason, we sustain the objection and note an exception to plaintiff.

NINTH EXCEPTION. The learned court erred in sustaining defendant's objection to the question of plaintiff's counsel, and in rejecting the testimony as follows:

Plaintiff's witness, William H. Weis, being on the stand, and having been qualified as an expert accountant of twenty-five years' experience, after plaintiff's offer as set forth in Exception No. 8 herein had been rejected, was asked the following question and upon objection of defendant's counsel thereto, the following ruling was made (Transcript, pp. 24–25):

Mr. RUSLANDER:

Q. State whether or not this transaction with Jouravleff was one which accountants would consider a bad debt, as distinguished from a loss.

Mr. BLAISDELL. To that we urge the same objections as heretofore urged to the offer of proof.

The COURT. We sustain this objection. We can not see that the opinion of this witness as an expert accountant, would have any value in ascertaining whether or not the item in question in this case comes within purview of the statute as to deductible losses or bad debts. We therefore sustain the objection and note an exception to the plaintiff.

TENTH EXCEPTION. The learned court erred in sustained defendant's objection to the admission in evidence of a telegram and rejecting it, as follows:

45 Plaintiff's witness, Clifton Taylor, being on the stand, after having identified as an original a telegram from Jouravleff to the plaintiff dated December 18, 1918, which was admitted in evidence (Plaintiff's Exhibit No. 1) and which contained a statement to the effect that the whole thing (meaning Pine Creek Tungsten Company, from the mines of which company Jouravleff expected to receive the ore with which to fulfill his contract with the plaintiff) had been taken out of his (Jouravleff's hands and placed in full control of a Bishop (California) banker, identified in similar manner as an original the following telegram (Plaintiff's Exhibit No. 2) dated December 22, 1918, from W. W. Watterson, president of the Inyo County Bank of Bishop, California, to the plaintiff:

LOS ANGELES, CALIF., *Dec. 22, 1918.*

ELECTRIC REDN. CO.,
*Washn., Pa.*

We are contemplating taking controlling interest in Pinecreek Tungsten Company owing to their getting in financial straits. Would like information relative Jouravleff contract with you what is tonnage price and terms and will deliver up to May or June.

Be acceptable if winter shuts off production. In addition this tonnage can you make firm offer for thirty tons sheetlite monthly say to December. Please wire answer here Los Angeles to-morrow forenoon if possible, care Angelus Hotel.

W. W. WATTERSON.
*President Inyo County Bank, Bishop, Calif.*

Whereupon the court sustained defendant's objection to the
46 offer of said telegram in evidence, as follows (Transcript, pp. 37–40):

Mr. RUSLANDER. Plaintiff's Exhibit No. 2 is offered in evidence.

Mr. BLAISDELL. Defendant objects to plaintiff's offered Exhibit No. 2 for the reason that it purports to have been received from some person who was an entire stranger to the contractual parties in this case; that is, it was not from Jouravleff, or any person associated

with him, apparently, and that the same is entirely incompetent, irrelevant, and immaterial, and can not tend to prove or disprove any issue in this case.

The COURT. We can not see what bearing this telegram would have on the issues here and how it would be proof of anything at all, so far as the issues here are concerned.

Mr. RUSLANDER. I overlooked a connecting link.

Q. Exhibit No. 1 speaks of the Pine Creek Tungsten Company getting into financial straits. Can you state whether or not Mr. Jouravleff was connected with this company in 1918?

A. Yes, sir; he was.

Q. Can you tell whether or not this was the company from which Jouravleff was to get the ore that was to be delivered to the Electric Reduction Company?

A. He was.

Q. Can you tell us whether or not this was the only place that Jouravleff could get this ore at that time?

Mr. BLAISDELL. Objected to, for the reason that it is incompetent, irrelevant, and immaterial to any issue in this case, and it
47 would be manifestly beyond the power of this witness to testify unless it be shown that he is so qualified.

The COURT. Yes; he would have to know what the capacities of Jouravleff were in the matter of securing ore. It does not appear that he is competent to answer that question.

Mr. RUSLANDER:

Q. Can you tell us whether or not this was the place where Jouravleff was stationed when he sent the telegram, Exhibit No. 1?

A. Yes, sir.

Q. Can you tell us whether or not this mine from which he was to ship ore, was the Pine Creek Tungsten Company's mine?

A. Yes.

Mr. BLAISDELL. I move to strike that out. There is no proper foundation shown that this witness is qualified to testify as to where Mr. Jouravleff was to get his ore, or what were Mr. Jouravleff's limits as to the possibilities of obtaining ore, or where he was stationed.

The COURT. Yes; this must be stricken out. We can not see how a statement by this man who signed himself as president of this Inyo County-Bishop Bank of California, would be evidence that could properly sustain a finding that Jouravleff was financially or otherwise unable of making delivery of ore as contracted for. Persons actually familiar with Jouravleff's financial responsibility and capacity and his power to deliver ore might properly be called to testify, but this witness merely inquiring of others, could not bring here the reports that they made to him, as competent testi-
48 mony. If a man's reputation as to financial responsibility in carrying out a contract, is to be testified to, it must be by witnesses who are familiar with him and his capacity to carry out

the contract. We sustain the objection to the offer of this telegram, and note an exception to plaintiff.

Eleventh exception. The learned court erred in sustaining defendant's objection to the question of plaintiff's counsel, and in rejecting the testimony as follows:

Plaintiff's witness, Clifton Taylor, being on the stand and having testified that, in making an investigation for the purpose of verifying the statement contained in the telegram from Jouravleff (Plaintiff's Exhibit No. 1) to the effect that Jouravleff had an interest in a Baltimore tungsten smelting plant, he learned from the president of the said company that Jouravleff had an interest in the said company, was asked the following question by plaintiff's counsel, and upon objection of defendant's counsel thereto, the following ruling was made (Transcript, pp. 41–42):

Mr. RUSLANDER:

Q. Did you ascertain in that manner whether or not the interest was worth anything in money?

Mr. BLAISDELL. I object to this as incompetent, irrelevant, and immaterial, and as not having any bearing on this case. That is objected to as immaterial.

The COURT. I can not see the materiality of this testimony, and, furthermore, we do not think it is competent to show by this witness what the president of the company inquired about may have told him with reference to the interest of the other person. If
49 you propose to show by the testimony of the proper witness, and persons familiar with that company, the relation of Jouravleff to it, there is direct evidence that you might produce, if it is competent at all; and it can not be proved by what some officer of the company may have told this witness. We sustain the objection and note an exception to the plaintiff.

Twelfth exception. The learned court erred in rejecting plaintiff's offer of evidence as follows:

Plaintiff's witness, Clifton Taylor, being on the stand, and having testified that he had in 1918 made an extensive investigation as to the ability of Jouravleff to perform his contract with plaintiff, the following offer and ruling occurred (Transcript, pp. 44–46):

Mr. RUSLANDER. Counsel for plaintiff proposes to prove by the witness on the stand that after the receipt of the telegram, Exhibit No. 1, dated December 18, 1918, all within the year 1918, he endeavored to secure his company through Jouravleff's interests in the Baltimore tungsten smelting plant, and was informed by Hardy, who claimed to be acting under power of attorney from Jouravleff and who was Jouravleff's agent in the dealings with the Electric Reduction Company, that the stock was up as collateral and not in Jouravleff's possession, and could not be delivered—the stock in the Baltimore Tungsten Smelting Company—and that the only interest that Jouravleff had in that company was stock. This for the purpose of showing the effort made by the company

50 during the year 1918, to protect itself from loss; that it never did get the stock or get any other property.

Mr. BLAISDELL. This offer is objected to as immaterial, incompetent, and irrelevant, and as not tending to prove or disprove any issues in this case. Further, the testimony we think is necessarily hearsay, to a large extent, and would be in the nature of self-serving facts, and could not affect or change the facts in issue, and that whether or not the plaintiff obtained or attempted to obtain the capital stock in question as security for Jouravleff's debt, is entirely immaterial, irrelevant, and incompetent, and can not affect any issue in this case.

Mr. RUSLANDER. It is in issue in the case because it is a distinct allegation in the plaintiff's statement of claim, which is denied by the defendant.

The COURT. The trouble with the offer as a whole is this, you are offering to show the results of the witness's investigation in the shape of reports made to him by persons of whom he inquired. Certainly, what the party may have told this witness on the subject matter of the investigation is not competent evidence. If the testimony which Mr. Hardy could give would be competent in this case, of course he should be called, in order that he may testify in court and be subjected to cross-examination by the other side. This witness might testify as to what he did personally in an effort to secure ore, or to secure a return of the advancement made, or the failure to get ore, but that is as far as the testimony of this witness
51 could properly go. The offer as a whole is objectionable, therefore, and we sustain the objection and note an exception to the plaintiff.

*Order settling bill of exceptions*

The plaintiff, Electric Reduction Company, complaining that sundry errors were committed in the trial of said cause, tenders the foregoing bill of exceptions to the actions and rulings of said court and prays that the same may be settled and sealed and made a part of the record, and is so accordingly done and ordered this 14th day of September, A. D. 1925.

PER CURIAM.

[SEAL.] *S.*

In United States District Court

*Opinion, filed July 9, 1925*

SCHOONMAKER, J.: This is an action at law to recover income and profit taxes paid by plaintiff for the year 1918. It involves an interpretation of the revenue act of 1918, sec. 234 (a), (4), and (5), which provides:

"SECTION 234 (a). That in computing the net income of a corporation subject to tax imposed by section 230, there shall be allowed as deductions:

"(4) Losses sustained during the taxable year and not compensated by insurance or otherwise.

"(5) Debts ascertained to be worthless and charged off within the taxable year."

52 The plaintiff claims, under this section, a deduction from its 1918 income of $27,205.35, advanced by it to one Jouravleff as part payment of the purchase price of certain tungsten ore which was never delivered and which sum the plaintiff was unable to recover from Jouravleff.

The plaintiff contends that this sum was a deductible loss and the Government claims that it was a bad debt which the plaintiff is not entitled to deduct because it did not charge it off on the books of the company during the year 1918.

The case was tried before the court without a jury under agreement of the parties waiving a jury trial.

From the admissions of parties and the proofs offered at the trial we find the following facts:

"1. The Electric Reduction Company, plaintiff, claims of C. G. Lewellyn, former Collector of Internal Revenue, the defendant, the sum of $7,051.55, with interest upon $867.22 thereof from March 15, 1919, and upon $2,092.41 thereof from June 15, 1919, and upon $2,045.91 thereof from September 15, 1919, and upon $2,045.91 thereof from December 15, 1919, as additional corporation income tax, which said amounts were paid to the defendant collector on the respective dates set forth.

"2. The Electric Reduction Company, the plaintiff, is a corporation duly organized, under the laws of the State of Delaware, with its principal place of business in Pittsburgh, Pennsylvania.

53 "3. C. G. Lewellyn, the defendant, at the times of payment of said tax of $7,051.55, was the collector of internal revenue for the twenty-third district in the Commonwealth of Pennsylvania.

"4. The Electric Reduction Company duly filed its income and profits tax return for the year 1918, which showed a tax liability of $8,183.63, which said tax was duly paid to C. G. Lewellyn, the then collector of internal revenue.

"5. On or about November 29, 1922, the Electric Reduction Company filed an amended income and profits tax return for the year 1918, showing a tax liability for said year of $1,132.78, and claiming a loss sustained for the year 1918 in the sum of $27,205.35, as is more particularly shown hereinafter. With said amended return it filed a claim for refund in the sum of $7,050.85, being the difference between the tax liability shown on the amended return for 1918 and the tax liability shown on the original return for 1918, which was paid. Said claim for refund was rejected by the commissioner by letter dated April 17, 1923, upon the ground that the loss was not finally and definitely determined to be a loss until 1922, and was not charged off as such until 1922.

"6. The reason alleged by the Electric Reduction Company for the filing of the claim for refund and the amended return was that it

claimed to have suffered a deductible loss of $27,205.35 in the year 1918, which was not deducted as a loss for said year 1918 in the original return filed.

"7. The transaction on which said claim of loss is based was as follows:

54 "8. The Electric Reduction Company entered into a contract with one Konstantine Jouravleff, dated July 2, 1918, and accepted July 3, 1918. Jouravleff therein agreed to deliver to the Electric Reduction Company one hundred fifty (150) tons of tungsten ore sheelite at said company's factory, Washington, Pennsylvania, in shipments of one car of 30 to 35 tons each month, beginning August, 1918, through to the end of the year; payments, $24.00 per unit. It is agreed that Exhibit 6 attached to plaintiff's statement is a true and correct copy of said contract. The Electric Reduction Company agreed to and did accept a trade acceptance for $30,000 in favor of said Jouravleff, payable in sixty days, to apply on and to be deducted from the amount which would be due Jouravleff when he made the first shipment of ore. It is agreed that Exhibit 7 attached to plaintiff's statement is a true and correct copy of said trade acceptance.

"9. Prior to the making of said contract Jouravleff was unknown to the Electric Reduction Company; he was introduced by one Charles Hardy, a broker handling ores, who, to induce the plaintiff to enter into the said contract, verbally represented that said Jouravleff was a reputable business man of unquestioned integrity and financial responsibility, and that he was in a position to deliver tungsten ore in accordance with said contract.

"10. At the time of making the contract between Jouravleff and the Electric Reduction Company, and in order to induce said company to agree to the terms thereof and to give the acceptance provided for in said contract, the said Charles Hardy, at the request of the said company, verbally undertook to keep the said com-

55 pany fully informed concerning the deliveries of tungsten ore to be made by said Jouravleff under said contract, which deliveries were to be made at a point distant from said company's place of business and its plant, and also concerning the progress said Jouravleff was making in mining and concentrating the said tungsten ore to be used in the fulfilling and performance of said contract, as well as following up and seeing to the deliveries of said tungsten ore by said Jouravleff.

"11. After the making of the contract between Jouravleff and the Electric Reduction Company, said company performed the same on its part to be performed, and executed and delivered to said Jouravleff the acceptance provided for in the contract for $30,000.

"12. The said acceptance was given to Jouravleff with the agreement that it was to cover and be deducted from the price of the first car of tungsten ore to be shipped, which car was to be shipped before the maturity of the trade acceptance on August 30, 1918; and

that if said car was not shipped and delivered as agreed, the plaintiff was at liberty to refuse to pay the said trade acceptance.

"13. The said Charles Hardy had full knowledge of the terms and conditions under which said trade acceptance was given.

"14. John MacGregor Grant, Inc., was, in 1918, a corporation organized under the laws of the State of New York, engaged in the brokerage and banking business, had its principal place of business in New York city, and was a backer and promoter of the enterprise in which Jouravleff was engaged.

56 "15. The said trade acceptance for $30,000 was made negotiable and unconditional, and was placed before maturity with John MacGregor Grant, Inc.

"16. John MacGregor Grant, Inc., with full knowledge of the facts, and with full knowledge of the fact that the said Jouravleff had not shipped or delivered, and was not able to ship or deliver any car of tungsten ore, as required by the contract between Jouravleff and the Electric Reduction Company, negotiated for the said Jouravleff the said acceptance to innocent holders, without notice, and received therefor the sum of $30,000.

"17. The Electric Reduction Company duly paid the trade acceptance of $30,000 on August 30, 1918, at maturity, to the holder thereof.

"18. Subsequent to the making of the contract between Jouravleff and the Electric Reduction Company, and before the maturity of said trade acceptance on August 30, 1918, the Electric Reduction Company, from time to time, inquired of Charles Hardy concerning the progress that the said Jouravleff was making in mining tungsten ore, and the said Hardy promised to investigate and report.

"19. The Electric Reduction Company was induced to pay said trade acceptance by receipt of a telegram from Charles Hardy, and in reliance thereon. Said telegram is as follows:

AUGUST 29, 1918.

ELECTRIC REDUCTION COMPANY,
*Washington, Pa.*

Reference contract Jouravleff. Shipment one car will be made today.

HARDY.

57 "The information given in said telegram was false. No car was ever shipped.

"20. The Electric Reduction Company, from time to time, made efforts to obtain from the said Jouravleff shipments of tungsten ore under the terms of the contract between them, and to obtain repayment of the said sum of $30,000.00, but no part of said contract was ever carried out by the said Jouravleff, except the said company received from Jouravleff in December, 1918, fifty-six (56) bags containing 4,468.24 pounds of sheelite concentrates (tungsten ore) of a value of $2,784.65, which amount the Electric Reduction Company applied on said trade acceptance of $30,000.

"21. The Electric Reduction Company in March, 1919, brought three suits in the Supreme Court of the County of New York, State of New York; one against Konstantine Jouravleff; one against John MacGregor Grant, Inc., and one against Charles Hardy, the broker, to recover the said sum of $27,205.35. Judgment was obtained against the said Jouravleff in 1919, in said suit against him. The said judgment proved worthless as the said Jouravleff had no assets and had disappeared. In 1921 the said suit against John MacGregor Grant, Inc., was discontinued as worthless as the defendant in that action had been adjudged bankrupt after the commencement of the suit. In the suit against Charles Hardy, the trial court, on November 23, 1922, directed a verdict against the therein plaintiff, upon the special defense of Hardy that the alleged agreement between the Electric Reduction Company and him constituted a special promise by Hardy to answer for the debt, default or miscarriage of
58 another person, and that said promise, note or memorandum was not made in writing or subscribed by Hardy, and was void under the Statute of Frauds.

"22. The Electric Reduction Company did not charge off the amount of $27,205.35 as a loss upon said trade acceptance until November, 1922, but carried the said amount of $27,205.35 on the books of the company during the year 1918, as a bills receivable item, and the item was so carried until November 29, 1922, or thereabout, when the amended tax return for the year 1918 was filed and the said amount was then charged off as a loss."

On this state of facts we find as a matter of law that the plaintiff is not entitled to recover.

The transaction involved is one of debt falling within the provisions of sec. 234 (a) (5) of the revenue act of 1918, hereinbefore quoted. Therefore, inasmuch as this debt was not ascertained to be worthless and charged off during the year 1918, the plaintiff is not entitled to the deduction claimed.

The obligation arising out of the contract between the plaintiff and Jouravleff was clearly one of debt and comes within the definition of that term under all the authorities, among which may be noted the following definition of the word "debt":

"A sum of money due by certain and express agreement."

"All that is due a man under any form of obligation or promise." (Bouvier's Law Dictionary—Rawles third revision, vol. 1, p. 786.)

59 "A sum of money due upon contract, express or implied. In a larger sense, the word means that which one person is bound to pay to another, or to perform for his benefit; a sum of money due from one person to another, whether money, goods, or services; due; all that is due under any form of obligation or promise." (Corpus Juris, vol. 17, p. 1373.)

"Any money, goods or services that one is bound to pay to another." (Idem, p. 1374, note (46 (a)).)

"In the most extensive sense of the term, everything is a debt which is of absolute obligation." (Idem, p. 1375.)

"It might be properly and safely laid down as a general rule that all obligations arising from contracts, either express or implied, either for the payment of money or the delivery of goods, create a debt on the part of the obligor." (Hunt v. Norris, 4 Mart. (La.), 517–532.)

We have under the statute, two classes of deductions (1) bad debts ascertained to be worthless and charged off during the taxable year, and (2) losses sustained and not compensated for by insurance or otherwise.

It thus clearly appears that a loss arising from a bad debt is not the character of a loss that is an allowable deduction under sec. 234 (a) (4) above, for had it been so intended there would be no necessity for specifying the two classes of allowable deductions. The plaintiff lost the money it paid Jouravleff on account of the purchase price of ore, but that loss arose out of a bed debt which to
60 be claimed as a deduction from income, must be charged off during the taxable year. This was not done. The plaintiff can not recover.

Judgment may be entered in this case in favor of defendant and due exception noted to the plaintiff.

In United States District Court

*Judgment, filed July 9, 1925*

Pursuant to the foregoing action of the court, judgment is hereby entered in favor of the defendant.

J. Wood Clark, *Clerk.*

61 In United States District Court

Filed September 10, 1925

And now, September 10th, 1925, comes Electric Reduction Company, plaintiff above named, the plaintiff in error, by its attorney, S. Leo Ruslander, and respectfully makes and files the following assignment of errors:

[Assignments of error omitted; printed side page 38, ante.]

73 Wherefore the said Electric Reduction Company, for the reason of the errors assigned, prays that the judgment of the United States District Court for the Western District of Pennsylvania be reversed.

S. Leo Ruslander,
*Attorney for Electric Reduction Company.*

74 **In United States District Court**

*Stipulation re transcript of record*

**Filed September 14, 1925**

And now, September 14, 1925, it is hereby agreed by and between counsel for plaintiff and defendant, that the following shall be printed as and constitute the record in the above cause before the United States Circuit Court of Appeals for the Third Circuit, namely:

1. Docket entries.
2. Statement of claim, omitting the exhibits attached thereto.
3. Affidavit of defence.
4. Requests for findings of fact and conclusions of law ex parte plaintiff.
5. Bill of exceptions.
6. Opinion of the court below.
7. Judgment entered.
8. Assignment of errors.
9. Stipulation for record.

S. LEO RUSLANDER,
*Attorney for Plaintiff.*
JOHN D. MEYER,
*United States Attorney,*
*Attorney for Defendant.*

75 [Clerk's certificate to foregoing transcript omitted in printing.]

76 [Minute entry of argument and submission Nov. 5, 1925, omitted in printing.]

77 In United States Circuit Court of Appeals for the Third Circuit

ELECTRIC REDUCTION COMPANY, PLAINTIFF IN ERROR

v.

C. G. LEWELLYN, COLLECTOR OF INTERNAL REVENUE FOR THE TWENTY-third District of the United States, defendant in error

No. 3408, October Term, 1925

*In error to the District Court of the United States for the District of Pennsylvania*

**Opinion filed February 27, 1926**

Before Buffington, Woolley, and Davis, Circuit Judges.

DAVIS, Circuit Judge: On July 2, 1918, plaintiff below, Electric Reduction Company, agreed to purchase from one Jouravleff one

hundred and fifty to one hundred and seventy-five tons of tungsten ore. Jouravleff was to ship a car of thirty to thirty-five tons each month beginning in August, 1918. The plaintiff was "to establish immediately a banker's acceptance for $30,000 in favor of the seller for 60 days to cover and to be deducted from the first car shipped. A like acceptance to be issued, *in* necessary, on each following car." On August 29, 1918, Charles Hardy, who represented Jouravleff, telegraphed the Reduction Company: "Reference contract Jouravleff shipment one car to be made to-day." The Reduction Company, relying upon the truth of the telegram, thereupon sent its trade acceptance for $30,000 to Jouravleff. The car of ore was not shipped that day nor at any other time. However, ore to the value of $2,784.65 was subsequently shipped. Jouravleff negotiated the trade acceptance to an innocent holder for value and so the plaintiff had to pay it at maturity. The plaintiff brought suit against Jouravleff and Hardy, who had guaranteed the payment, for the amount of his loss, $27,205.35, but they were financially irresponsible.
78 The litigation lasted until 1922, when the plaintiff charged off the amount on its books and amended its tax return for 1918. The Commissioner of Internal Revenue denied the right to charge off this loss for 1918 and assessed additional taxes, which were paid under protest. A return was demanded, but was refused, and thereupon this suit was brought. The case was tried by agreement before the court without a jury. Judgment was entered against the plaintiff.

The question is whether or not the so-called loss comes within subdivision (4) or (5) of section 234 (a) of the revenue act of 1918. The act provides as follows:

"SECTION 34. (a) That in computing the net income of a corporation subject to the tax imposed by section 230, there shall be allowed as deductions—

(4) Losses sustained during the taxable year and not compensated for by insurance or otherwise.

(5) Debts ascertained to be worthless and charged off within the taxable year." (40 Stat. 1057.)

If the $27,205.35 is a "loss" within the meaning of subdivision (a) (4), it may be deducted from the income of 1918, as it was actually "sustained" in that year. If it was a bad "debt" within the meaning of (a) (5), it may not be deducted from the income of that year because it was not "ascertained to be worthless and *charged off* within the taxable year" of 1918.

According to the original return the company was liable for a tax of $8,183.63. If the $27,205.35 had been allowed as a loss sustained in the year 1918, the tax for that year would have been reduced to $1,132.78.

Congress doubtless had in mind a distinction between a loss and a worthless debt. Every worthless debt is allowed as a deduction if it is ascertained to be worthless and is charged off within the taxable year. So far as allowance as a deduction is concerned, a loss and a

worthless debt amount to the same thing, if the latter is charged off in time.

Words do not always mean the same thing. "A word is not a crystal, transparent and unchanged; it is the skin of a living thought and may vary greatly in color and content according to the circumstances in which it is used." Lamar v. United States, 240 U. S. 60.

The word "*bedt*" has no fixed legal meaning as does the word
79 "contract." Alimony is sometimes said to be a debt and sometimes not a debt. The word has several recognized meanings which vary greatly according to the subject matter and language used in connection with it. Hornbeck v. State, 71 N. E. 916; McNeal v. Waco, 89 Texas 83; In re Nowell, 99 Fed. 931. Bouvier says a debt is "a sum of money due by certain and express agreement." Neither does the word "loss" have a hard and fast meaning. "Failure to keep that which one has is a loss." Foehrenbach v. German American Title and Trust Company, 217 Pa. 332. There are many kinds of loss: Money out of pocket; a judgment changing the status from solvency to insolvency. Schambs v. Fidelity & Casualty Co., 259 Fed. 55, 58. In some cases the words "loss" and "debt" are interchangeable, but in others they are not. Mercantile Credit Guarantee Co. v. Wood et al., 68 Fed. 529, 533. Again "loss" may be synonymous with "destruction"—loss or destruction of property, Hawkins v. Haines, 71 Ga. 40; Richmond & E. R. Co., 88 Ga. 805.

Some definitions of "loss" cover the transaction in question. The plaintiff failed to keep what it had and parted with it through fraud and misrepresentation. On the other hand there are definitions of "debt" which do not include this transaction. The $27,205.35 was not due the plaintiff by a "certain and express agreement." At no time did Jouravleff by a "certain and express agreement" promise to pay anything. He promised to send ore, not to pay money, and because he did not keep that promise, the plaintiff sustained a loss. Some losses, such as the loss of a building by fire, may be "compensated for" by insurance. Others, such as the loss of a bad account, may be "compensated for" "otherwise," by the guaranty of a factor or in some other way. The plaintiff did not lose the entire $30,000, but it did lose $27,205.35 which was not compensated for by insurance, or otherwise.

The loss was sustained in 1918, the taxable year. In that year the money was paid and was never recovered. That the plaintiff was engaged in litigation three or four years in an effort to recover it and did not charge it off until 1922, do not change the fact nor time of the loss. The entry of the charge-off was a mere bookkeeping transaction. It neither created nor changed any fact. It
80 simply recorded the fact which had existed for four years. Baldwin Locomotive Works v. McCoach, 221 Fed. 59, 60; Doyle, Collector, v. Mitchell Brothers Co., 247 U. S. 179.

In the construction of a taxing statute doubts should be resolved against the Government and in favor of the taxpayer. American Net & Twin Co. v. Worthington, 141 U. S. 468, 474; Benziger v.

United States, 192 U. S. 38, 55; Gould v. Gould, 245 U. S. 151. It is not clear to us that the term "losses" in subdivision (a) (4) of section 234 of the act does not include the loss of the $27,205.35. Therefore the judgment of the District Court is reversed and a new trial granted.

81 In United States Circuit Court of Appeals for the Third Circuit

[Title omitted.]

*Judgment, filed Feb. 27, 1926*

In error to the District Court of the United States for the Western District of Pennsylvania.

This cause came on to be heard on the transcript of record from the District Court of the United States for the Western District of Pennsylvania, and was argued by counsel.

On consideration whereof, it is now here ordered and adjudged by this court that the judgment of the said district court in this cause be, and the same is hereby, reversed and a new trial granted.

J. WARREN DAVIS,
*Circuit Judge.*

PHILADELPHIA, *February 27, 1926.*

[File indorsement omitted.]

82 In United States Circuit Court of Appeals

*Mandate, filed March 29, 1926*

*The President of the United States of America, to the honorable the judges of the District Court of the United States for the Western District of Pennsylvania, greeting:*

Whereas lately in the District Court of the United States for the Western District of Pennsylvania, before you or some of you, in a cause between Electric Reduction Company (plaintiff below), plaintiff in error, and C. G. Lewellyn, collector of internal revenue (defendant below), defendant in error, a judgment was entered in the said district court on the ninth day of July, 1925, which judgment is of record in the office of the clerk of the said district court, to which reference is hereby made, and the same is hereby expressly
83 made a part hereof, as by the inspection of the transcript of the record of the said District Court, which was brought into the United States Circuit Court of Appeals for the Third Circuit by virtue of a writ of error agreeably to the act of Congress, in such case made and provided, more fully and at large appears.

84 And whereas, in the term of October, in the year of our Lord one thousand nine hundred and twenty-five, the

said cause came on to be heard before the said United States Circuit Court of Appeals on the said transcript of record and was argued by counsel:

On consideration whereof, it is now here ordered and adjudged by this court that the judgment of the said district court in this cause be, and the same is hereby, reversed and a new trial granted.

PHILADELPHIA, *February 27, 1926.*

85 You, therefore, are hereby commanded that such execution and further proceeding be had in said cause, as according to right and justice and the laws of the United States, ought to be had, the said writ of error notwithstanding.

Witness, the Honorable William Howard Taft, Chief Justice of the Supreme Court of the United States, at Philadelphia, the twenty-ninth day of March, in the year of our Lord one thousand nine hundred and twenty-six.

SAUNDERS LEWIS, JR.,
*Clerk of the U. S. Circuit Court of Appeals, Third Circuit.*

[File indorsement omitted.]

86 [Clerk's certificate to foregoing transcript omitted in printing.]

87 In Supreme Court of the United States

*Order allowing certiorari, filed October 11, 1926*

The petition herein for a writ of certiorari to the United States Circuit Court of Appeals for the Third Circuit is granted. And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

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# In the Supreme Court of the United States

OCTOBER TERM, 1925

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No. ——

C. G. LEWELLYN, COLLECTOR OF INTERNAL REVENUE for the Twenty-third District of the United States in the Western District of Pennsylvania, Petitioner

*v.*

ELECTRIC REDUCTION COMPANY, A CORPORATION Organized and existing under the Laws of the State of Delaware

---

**PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT**

The Solicitor General, on behalf of C. G. Lewellyn, Collector of Internal Revenue for the Twenty-third Pennsylvania District, prays that a writ of certiorari issue to review the judgment of the Circuit Court of Appeals for the Third Circuit (R. 79) entered in the above case February 27, 1926, reversing the judgment of the United States District Court for the Western District of Pennsylvania (R. 60).

## QUESTIONS PRESENTED

This case presents another phase of the same question involved in *United States* v. *S. S. White Dental Company,* No. 957, on the docket of this Court for the present term, in which, upon the request of the Government, a writ of certiorari was granted on April 19, 1926.

The questions are:

1. Is respondent, under Section 234 (a) (4) of the Revenue Act of 1918, entitled to deduct in computing net income for the year 1918, as a *loss* " sustained during the taxable year," the sum of $27,205.35, representing an unpaid balance of money advanced for the purchase of ore, or should the deduction be taken for the year 1922?

2. Is respondent, under Section 234 (a) (5) of the Revenue Act of 1918, entitled to deduct in the year 1918 said sum of $27,205.35 as a *debt* " ascertained to be worthless and charged off within the taxable year," or should the deduction be taken for the year 1922?

## STATEMENT

On July 3, 1918, respondent, a Delaware corporation, entered into a written contract with one Konstantine Jouravleff by virtue of which the latter agreed to deliver from 150 to 175 tons of tungsten ore at respondent's factory at Washington, Pennsylvania. Delivery was to be made in monthly carload shipments of from 30 to 35 tons, beginning with the month of August, 1918. Under the terms of the contract it was agreed that respondent should

immediately accept a draft for $30,000 in favor of Jouravleff to cover and be deducted from the purchase price of the first car of ore shipped. Like drafts were to be accepted, if necessary, on subsequent shipments. (R. 34, 52, 54.)

Jouravleff was unknown to respondent. The contract with him had been entered into upon the representations of one Charles Hardy, a broker, that Jouravleff was a reputable business man, financially responsible and able to carry out the terms of the contract. A draft was drawn by Jouravleff for $30,000, dated July 1, 1918, upon which respondent indorsed an acceptance. (R. 35, 54.) Jouravleff immediately negotiated this draft through John MacGregor Grant, Inc., bankers and brokers of New York, to an innocent holder for value. (R. 56.) This firm of bankers were backers of Jouravleff and had knowledge of the terms of the contract and the conditions under which the draft was issued. (R. 55–56.) Hardy, the broker, had agreed to keep respondent informed concerning the progress made by Jouravleff in mining and shipping the ore. (R. 54–55.) On August 29, 1918, he telegraphed respondent as follows: " Reference contract Jouravleff. Shipment one car will be made to-day." In reliance upon this information, on August 30, 1918, respondent paid to the holder the full amount of the draft. (R. 56.) No carload of ore was shipped then or at any other time. All the ore ever received by respondent from Jouravleff

was 56 bags containing some 4,500 pounds, of the value of $2,794.65, received in December, 1918. This sum was credited to the account of $30,000, leaving a balance of $27,205.35 due respondent from Jouravleff. (R. 57.)

In March, 1919, respondent instituted three separate suits in the Supreme Court of the County of New York, to recover said sum of $27,205.35—one against Jouravleff, one against John MacGregor Grant, Inc., and the other against Charles Hardy. The judgment obtained against Jouravleff in 1919 proved worthless, as he had disappeared, leaving no property. The suit against John MacGregor Grant, Inc., was discontinued in 1921 as worthless, the defendant having been adjudged bankrupt. On November 23, 1922, the New York court directed a verdict in Hardy's favor, on the ground that the alleged agreement between him and respondent constituted a specific promise to answer for the debt, default, or miscarriage of another person and, not having been reduced to writing, was void under the Statute of Frauds. (R. 57–58.)

Respondent did not charge off the sum of $27,205.35 in 1918, when Jouravleff failed to perform his obligation, but continued to carry it on its books under " Bills Receivable " (R. 58), and for that year it filed an income and profits tax return showing a tax liability of $8,183.63, which amount it paid. Upon the termination in 1922 of the above-mentioned litigation, however, the company filed an amended return for 1918, in which the loss was

claimed as a deduction, leaving a total liability for 1918 amounting to $1,132.78. With this amended return a claim was filed for a refund of $7,050.85, being the difference between the tax liability claimed in the amended return and the amount paid upon the original return. (R. 53.) The Commissioner of Internal Revenue rejected this claim for refund; whereupon this action was brought in the United States District Court for the Western District of Pennsylvania for recovery. (R. 5.)

The District Court (R. 51–60; 8 F. (2d) 91) held that the sum of $27,205.35 represented a "bad debt" rather than a " loss " and that therefore under the provisions of Section 234 (a) (5) of the Revenue Act of 1918 it could only be deducted in the year actually charged off the books, which in this case was 1922. Upon writ of error the Circuit Court of Appeals for the Third Circuit reversed the judgment of the District Court, holding that the amount was not a " bad debt," but a " loss "; that therefore the provisions of Section 234 (a) (4) of the Revenue Act of 1918 applied and that the loss was *sustained* in the taxable year 1918. (R. 76–79; not yet reported.)

It is the position of the Government that the sum of $27,205.35 represented a debt and under Section 234 (a) (5) was deductible in 1922, the year in which it was admittedly charged off the books. It is the further contention of the Government that even if said sum represents a loss, as held by the

Circuit Court of Appeals, as such it could only be deducted under Section 234 (a) (4) when evidenced by a closed and completed transaction, which in this case would not be until the termination of the litigation in 1922.

### STATUTE INVOLVED

The Revenue Act of 1918 (Ch. 18, 40 Stat. 1057, 1077–1078) provides:

> Section 234. (a) That in computing the net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions:
>
> * * * * *
>
> (4) Losses sustained during the taxable year and not compensated for by insurance or otherwise;
>
> (5) Debts ascertained to be worthless and charged off within the taxable year.

### REASONS FOR GRANTING THE WRIT

1. The Circuit Court of Appeals erred in holding that the sum of $27,205.35 represented a "loss" instead of a "bad debt" and that under Section 234 (a) (4) of the Revenue Act of 1918 it was sustained in the year 1918.

2. While each case presents a different state of facts, the principle involved in the instant case is the same as that involved in the case of *United States* v. *S. S. White Dental Company,* now pending before this Court on a writ of certiorari granted on April 19, 1926. In the *S. S. White Dental Company case* the taxpayer claimed the right to deduct

as a loss the value of the property of a subsidiary which was sequestered by Germany during the war before it had been ascertained whether or not compensation therefor would be made by Germany. In the instant case the right is claimed to deduct a so-called "loss" in the year 1918, at which time litigation for its recovery had not terminated.

The principle involved in this and the *S. S. White Dental Company case* is one of great importance to the Bureau of Internal Revenue in the administration of the taxing statutes. The Treasury Department has always provided in its regulations, which it has consistently carried out, that no loss could be deducted unless it was actually sustained within the taxable year as evidenced by a closed and completed transaction. The amount involved in this class of cases is very large. It is desirable, therefore, that a writ of certiorari issue in this case with the expectation that decisions on varying facts may result in the establishment of a settled rule for the guidance of the courts and the Treasury Department.

Wherefore it is respectfully submitted that this petition for a writ of certiorari to review the judgment of the Circuit Court of Appeals for the Third Circuit should be granted.

WILLIAM D. MITCHELL,
*Solicitor General.*

MAY, 1926.

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# PETITIONER'S BRIEF

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# In the Supreme Court of the United States

OCTOBER TERM, 1927

No. 71

C. G. LEWELLYN, COLLECTOR OF INTERNAL REVENUE for the Twenty-third District of the United States, etc., petitioner

*v.*

ELECTRIC REDUCTION COMPANY

*ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT*

## BRIEF FOR THE PETITIONER

### OPINIONS BELOW

The opinion of the District Court (R. 27–32) is reported in 8 F. (2d) 91. The opinion of the Circuit Court of Appeals (R. 33–36) is reported in 11 F. (2d) 493.

### JURISDICTION

The judgment to be reviewed was entered February 27, 1926. (R. 36.) Petition for a writ of certiorari was filed May 24, 1926, and was granted by this Court October 11, 1926, under the Judicial Code, Section 240(a), Act of February 13, 1925.

### THE QUESTION PRESENTED

The question presented is whether the respondent was entitled to deduct from gross income for 1918, as a loss sustained in that year, the sum of $27,205.35, representing an amount paid out on a trade acceptance as an advance on the purchase price of ore which was never delivered, or whether the deduction should be taken in 1922, when efforts to recover ended and the item was charged off the taxpayer's books.

It is necessary to determine whether the item in question should be classed as a debt admittedly not deductible from 1918 income because not "ascertained to be worthless and charged off within the taxable year," or as not a debt but a loss, and whether it resulted from a transaction closed and completed during 1918.

### STATUTE INVOLVED

The Revenue Act of 1918 (c. 18, 40 Stat. 1057, 1077–1078) provides:

> SEC. 234. (a) That in computing the net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions:
>
> * * * * *
>
> (4) Losses sustained during the taxable year and not compensated for by insurance or otherwise;
>
> (5) Debts ascertained to be worthless and charged off within the taxable year.

Article 141 of Regulations 45, relating to the income-tax provisions of the Revenue Act of 1918, and subsequent revisions, in dealing with the subject of deductible losses, has consistently provided as follows:

> They must usually be evidenced by closed and completed transactions.

**STATEMENT**

This is one of a group of three cases brought here with a view to working out some principle or rule to settle the questions constantly arising whether deductible items are debts or losses and when they are deductible.

The case was tried on a stipulation of facts and admissions in the pleadings, which were followed by findings of fact. (R. 28.)

On July 3, 1918, respondent, a Delaware corporation, entered into a written contract with one Konstantine Jouravleff by virtue of which the latter agreed to deliver from 150 to 175 tons of tungsten ore at respondent's factory at Washington, Pennsylvania. Delivery was to be made in monthly carload shipments of from 30 to 35 tons, beginning with the month of August, 1918.

The contract (R. 19, 29) provided:

> Buyers to establish immediately a banker's acceptance for $30,000 in favor of seller for 60 days to cover and to be deducted from first car shipped. A like acceptance to be issued, if necessary, on each following car.

Jouravleff was unknown to respondent. The contract with him had been entered into upon the representations of one Charles Hardy, a broker, that Jouravleff was a reputable business man, financially responsible and able to carry out the terms of the contract. A draft was drawn by Jouravleff for $30,000, dated July 1, 1918, upon which respondent indorsed an acceptance. (R. 19, 29.)

This draft was in the following form (R. 19):

> WASHINGTON, PENNA., *July 1, 1918.*
>
> $30,000.00.
>
> Sixty days after date ———— pay to the order of K. Jouravleff thirty thousand dollars and no/100 dollars. The obligation of the acceptor hereof arises out of the purchase of goods from the drawer.
>
> Value received and charge the same to account of
>
> K. JOURAVLEFF.

The findings state (R. 29):

> The said acceptance was given to Jouravleff with the agreement that it was to cover and be deducted from the price of the first car of tungsten ore to be shipped, which car was to be shipped before the maturity of the trade acceptance on August 30, 1918; and that if said car was not shipped and delivered as agreed, the plaintiff was at liberty to refuse to pay the said trade acceptance.

Jouravleff immediately negotiated this draft through John MacGregor Grant, Inc., bankers and brokers of New York, to an innocent holder for

value. This firm of bankers were backers of Jouravleff and had knowledge of the terms of the contract and the conditions under which the draft was issued. (R. 30.) Hardy, the broker, had verbally agreed to keep respondent informed concerning the progress made by Jouravleff in mining and shipping the ore. (R. 29.) On August 29, 1918, he telegraphed respondent as follows (R. 30):

> Reference contract Jouravleff. Shipment one car will be made to-day.

The findings state that the respondent was induced to pay the trade acceptance in reliance on the above telegram from Hardy (R. 30), but, as the findings elsewhere show that the trade acceptance had passed into the hands of a bona fide holder (R. 30), the telegram may not have been the sole reason for payment.

No carload of ore was shipped then or at any other time. All the ore ever received by respondent from Jouravleff was 56 bags containing some 4,500 pounds, of the value of $2,794.65, received in December, 1918. This sum was credited to the account of $30,000, leaving a balance of $27,205.35 due respondent from Jouravleff. (R. 30.)

In March, 1919, respondent instituted three separate suits in the Supreme Court of the County of New York, to recover said sum of $27,205.35—one against Jouravleff, one against John MacGregor Grant, Inc., and the other against Charles Hardy. The judgment obtained against Jouravleff in 1919

proved worthless, as he had disappeared, leaving no property. The suit against John MacGregor Grant, Inc., was discontinued in 1921 as useless, the defendant having been adjudged bankrupt. On November 23, 1922, the New York court directed a verdict in Hardy's favor, on the ground that the alleged agreement between him and respondent constituted a specific promise to answer for the debt, default, or miscarriage of another person and, not having been reduced to writing, was void under the Statute of Frauds. (R. 31.)

Respondent did not charge off the sum of $27,205.35 in 1918, when Jouravleff failed to perform his obligation, but continued to carry it on its books under "Bills Receivable" (R. 31), and for that year it filed an income and profits tax return showing a tax liability of $8,183.63, which amount it paid. Upon the termination in 1922 of the above-mentioned litigation, however, the company filed an amended return for 1918, in which the loss was claimed as a deduction, leaving a total liability for 1918 amounting to $1,132.78. With this amended return a claim was filed for a refund of $7,050.85, being the difference between the tax liability claimed in the amended return and the amount paid upon the original return. (R. 28.) The Commissioner of Internal Revenue rejected this claim for refund (R. 28); whereupon this action was brought in the United States District Court for the Western District of Pennsylvania for recovery. (R. 2.)

The District Court (R. 27–32) held that the sum of $27,205.35 represented a "bad debt" rather than a "loss," and that therefore under the provisions of Section 234 (a) (5) of the Revenue Act of 1918 it could only be deducted in the year actually charged off the books, which in this case was 1922. Upon writ of error the Circuit Court of Appeals for the Third Circuit reversed the judgment of the District Court, holding that the amount was not a "bad debt" but a "loss"; that therefore the provisions of Section 234 (a) (4) of the Revenue Act of 1918 applied and that the loss was *sustained* in the taxable year 1918. (R. 33–36.)

## SPECIFICATION OF ERRORS TO BE URGED

The Circuit Court of Appeals erred in holding that the item in question represented a loss within the provisions of Section 234 (a) (4) of the Revenue Act of 1918, instead of a debt within the provisions of Section 234 (a) (5).

The Circuit Court of Appeals, in treating the item as a loss rather than a debt, erred in holding that the loss was sustained in the taxable year 1918.

## SUMMARY OF ARGUMENT

The trade acceptance by the respondent and its payment at maturity gave rise to a debt in the respondent's favor, to be set off against its obligation to arise on shipment of the ore. It was so treated by the taxpayer and entered on its books as an Account Receivable. Treating the item as a debt,

it is governed by subdivision (5) of Section 234 (a), which, in dealing with debts, allows deductions only of—

> Debts ascertained to be worthless and charged off within the taxable year.

The debt in the instant case was admittedly not charged off until 1922.

If the item be held to constitute a loss instead of a bad debt, still the loss should not be deducted from 1918 income for the reason that it was not sustained during that year, as the transaction and ascertainment of the loss was not closed or completed until later.

## ARGUMENT

### I

### THE TRANSACTIONS BETWEEN RESPONDENT AND JOURAVLEFF CREATED THE RELATION OF CREDITOR AND DEBTOR

The giving and the payment of the trade acceptance, while directly related to the contract for purchase and delivery of ore, was in fact treated by the parties as an independent transaction. It was understood and treated by them as creating the relation of debtor and creditor. The debt arose in favor of the respondent to be set off *pro tanto* against the debt to arise in favor of Jouravleff on shipment of ore. It was entered by the respondent on its books as an Account Receivable. The transaction therefore differs in some respects from what

it would have been if it had taken the form of a payment by the respondent to Jouravleff as a partial payment on purchase price of ore to be delivered. It was really a loan of credit, which ripened into a debt in favor of the respondent when it paid the draft. Under the circumstances, the item partakes more of the nature of a debt, which is only deductible when it is both ascertained to be worthless and charged off within the taxable year, than it does of a loss, within the other subdivision, not compensated for by insurance or otherwise.

If the item in question is to be treated as a bad debt instead of a loss sustained, it is clear that it was not deductible for 1918, because bad debts to be deductible must not only be ascertained to be worthless but must be "charged off within the taxable year," and this item was not charged off until the effort to recover it terminated in 1922.

Of course, the failure to collect any debt results in a loss to the creditor, but in the various Revenue Acts Congress sought to place losses from bad debts in a classification separate and apart from the general run of losses in respect of the matter of deductions from income. It is generally a simple matter to determine when a loss is sustained by fire, flood, tornado, or other destruction of property, or by a drop in the value, followed by subsequent sales, but it is difficult sometimes to ascertain when a debt becomes worthless. It may have been worthless at the time credit was extended and

the debt created. Congress, consequently, put the matter of deducting bad debts very largely in the hands of the taxpayer himself by providing that a debt may be deducted from income in the year in which the taxpayer ascertains the debt to be worthless and charges it off his books. In this case the taxpayer should not be allowed to complain that its own treatment of this item was accepted by the Bureau of Internal Revenue.

But treating the item as properly coming under the head of loss sustained instead of a debt ascertained to be worthless, it nevertheless was not deductible for 1918.

In the application of the provision for deduction of losses sustained within the taxable year the Treasury Department has consistently provided, by regulation, that a loss is not sustained until the transaction is closed and completed. In that sense this loss was not sustained in 1918 merely because Jouravleff failed to ship ore.

As late as 1919 the respondent instituted a suit against Jouravleff to recover $27,205.35, the balance owing on account of the trade acceptance after crediting him with the contract price on ore shipped. It does not appear that Jouravleff's lack of responsibility was definitely ascertained until after the judgment was entered in that case. The findings state (R. 31):

> Judgment was obtained against the said Jouravleff in 1919, in said suit against him.

> The said judgment proved worthless as the said Jouravleff had no assets and had disappeared.

There was also a claim against John MacGregor Grant, Inc., for negotiating the draft to a bona fide holder, with knowledge that no ore had been shipped. This claim was considered substantial enough to justify the respondent in suing John MacGregor Grant, Inc., and the suit was not discontinued until 1921, as the result of the adjudication of the defendant as a bankrupt after the commencement of the suit. (R. 31.) There was also a claim by respondent against Hardy, made the basis of a suit against him commenced in 1919, as a guarantor of the obligation of Jouravleff, and it was not until 1922, at the trial of this case, that the claim was disposed of by a judgment against respondent on the ground that Hardy's obligation was not in writing and was void under the Statute of Frauds. It was following the outcome of the final suit against Hardy, in November, 1922, that the item was charged off its books by the respondent. If there is any effect in a case of this kind to be given to the regulation that a loss is not sustained until there is a closed and completed transaction, this was not a closed and completed transaction in 1918.

During the period of periodically increasing income-tax rates taxpayers were quite content to accept this regulation and its application by the Treasury Department, resulting, as it did, in delay-

ing deductions until the years of higher tax rates. After the tide turned and income-tax rates underwent periodical reduction, we find taxpayers insisting that deductions shall relate back to earlier years of high tax rates. Long after the event, and after the transaction has been completely wound up and closed, it is easy to look back and say the loss occurred at the time of the original transaction, but such an application of the statute would result in the frequent and continuous readjustment of income-tax returns for past years, and a construction of the law should not be adopted which produces that result if it may be properly avoided.

This case is one of three brought to this Court presenting different phases of this subject. Each case depends largely on its own facts, and the justification for bringing here this and the other cases referred to is the expectation that decisions on the varying facts of a number of cases may point out principles to guide the Treasury Department in dealing with this troublesome problem.

One of the cases, *United States* v. *S. S. White Dental Company,* decided May 16, 1927, dealt with the question whether an American taxpayer suffered a loss in 1918 through the seizure in that year of property in Germany, the seizure having been made by the German Government under its power to sequester and confiscate the private property of alien enemies found within its jurisdiction at the

outbreak of the war. The Court there held against the United States, the ground of the decision being that title to the property was gone at the seizure, leaving only a moral and not a legal obligation on the part of the German Government to pay it and only a chance of reimbursement as a matter—

> either of grace to the vanquished or exaction by the victor.

In the present case there was a definite legal obligation owing to the taxpayer, with guaranties supposed to be valuable, and it does not appear that the inability to enforce this obligation was established until after 1918.

The other case, *Malleable Iron Range Co.* v. *United States,* raised the question whether a judgment for damages for infringement of a patent became a deductible item in the year in which judgment for infringement was rendered or, appeal having been taken, in the year in which the judgment was affirmed by the Circuit Court of Appeals, or in the year in which the infringement appears to have occurred. That case was remanded to the Court of Claims for further findings.

### CONCLUSION

The circumstances of this case justify the conclusion of the District Court that the item here in question should be treated as a debt ascertained to be worthless and not deductible until charged off its books by the taxpayer, but, on the theory that

the item should be treated as a loss instead of a bad debt, there was ground for the conclusion of the Commissioner of Internal Revenue that the transaction was not closed until after 1918.

Respectfully submitted.

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OCTOBER, 1927.

○

(12)

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No. 71

IN THE

# Supreme Court of the United States

**October Term, 1927**

C. G. LEWELLYN, COLLECTOR OF INTERNAL REVENUE FOR THE TWENTY-THIRD DISTRICT OF THE UNITED STATES, ETC., PETITIONER

v.

ELECTRIC REDUCTION COMPANY,

*On Writ of Certiorari to the United States Circuit Court of Appeals for the Third Circuit.*

## BRIEF FOR RESPONDENT

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IN THE

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No. 71

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v.

ELECTRIC REDUCTION COMPANY,

---

*On Writ of Certiorari to the United States Circuit Court of Appeals for the Third Circuit.*

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## BRIEF FOR RESPONDENT

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### Opinions Below

The opinion of the United States District Court for the Western District of Pennsylvania (R. 27-32) is reported in 8 F. (2d) 91. The opinion of the United States Circuit Court of Appeals for the Third Circuit (R. 33-36) is reported in 11 F. (2d) 493.

## Jurisdiction

The judgment to be reviewed is that of the United States Circuit Court of Appeals for the Third Circuit. It was entered February 27, 1926, and is found in the Record at page 36. Petition for writ of certiorari was filed May 24, 1926, and was granted by this Court October 11, 1926, under the Judicial Code, Section 240 (a), Act of February 13, 1925.

## Statute Involved

The Revenue Act of 1918 (c. 18, 40 Stat. 1057, 1077, 1078) provides:

> "Sec. 234 (a) That in computing the net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions:
>
> * * *
>
> "(4) Losses sustained during the taxable year and not compensated for by insurance or otherwise;
>
> "(5) Debts ascertained to be worthless and charged off within the taxable year; * *"

## Statement of the Case

In this case on petition a writ of certiorari was granted to review the judgment of the Circuit Court of Appeals for the Third Circuit, whereby the final judgment of the District Court of the United States for the Western District of Pennsylvania entered in favor of the petitioner was ordered reversed and a new trial granted.

The admitted facts, stated more concisely than in petitioner's brief, are set out in the opinion of the Circuit Court of Appeals, which, with a few additions by coun-

sel for respondent shown in brackets [ ], are as follows (R. 33-34):

> "On July 2, 1918, plaintiff below, Electric Reduction Company, agreed to purchase from one Jouravleff one hundred and fifty to one hundred and seventy-five tons of tungsten ore. Jouravleff was to ship a car of thirty to thirty-five tons each month beginning in August, 1918. The plaintiff was 'to establish immediately a banker's acceptance for $30,000 in favor of the seller for 60 days to cover and to be deducted from the first car shipped. A like acceptance to be issued, if necessary, on each following car.' [To cover this provision of the contract, plaintiff executed and delivered to Jouravleff a trade acceptance for $30,000, to be paid only after the first car of ore was delivered.] On August 20, 1918, Charles Hardy, who represented Jouravleff, telegraphed the Reduction Company: 'Reference contract Jouravleff shipment one car to be made today.' The Reduction Company relying upon the truth of the telegram thereupon sent [paid] its trade acceptance for $30,000 to Jouravleff. The car of ore was not shipped that day nor at any other time. However, ore to the value of $2,784.65 was subsequently shipped. Jouravleff [had] negotiated the trade acceptance to [one who claimed to be] an innocent holder for value and [to whom] so the plaintiff had to pay it at maturity. The plaintiff brought suit against Jouravleff and Hardy, who had guaranteed the payment, for the amount of his loss, $27,205.35, but they were financially [or otherwise] irresponsible. The litigation lasted until 1922, when the plaintiff charged off the amount on its books and amended its tax return for 1918. The Commissioner of Internal Revenue denied the right to charge off this loss for 1918 and assessed additional taxes, which were paid under protest. A return was demanded but was refused, and thereupon this suit

was brought. The case was tried by agreement before the court without a jury. Judgment was entered against the plaintiff.

"The question is whether or not the so-called loss comes within subdivision (4) or (5) of section 234 (a) of the revenue act of 1918. The act provides as follows:

" 'Section [2] 34. (a) That in computing the net income of a corporation subject to the tax imposed by section 230, there shall be allowed as deductions:

" '(4) Losses sustained during the taxable year and not compensated for by insurance or otherwise;

" '(5) Debts ascertained to be worthless and charged off within the taxable year.' (40 Stat. 1057) If the $27,205.35 is a 'loss' within the meaning of subdivision (a) (4), it may be deducted from the income of 1918, as it was actually 'sustained' in that year. If it was a bad 'debt' within the meaning of (a) (5), it may not be deducted from the income of that year because it was not 'ascertained to be worthless and charged off within the taxable year' of 1918.

"According to the original return the company was liable for a tax of $8,183.63. If the $27,205.35 had been allowed as a loss sustained in the year 1918, the tax for that year would have been reduced to $1,132.78."

The trial court made a specific finding of fact that (R. 30):

"19. The Electric Reduction Company was induced to pay said trade acceptance by receipt of a telegram from Charles Hardy, and in reliance thereon. Said telegram is as follows:

'August 29, 1918.

Electric Reduction Company,
Washington, Pa.

Reference contract Jouravleff Shipment one car will be made today

Hardy'

The information given in said telegram was false. No car was ever shipped."

Respondent had no income to absorb the loss after 1918, and the right to the deduction in later years as conceded by petitioner is of no real value (R. 22).

## Summary of Points

(1) *The transaction in question resulted in a "loss" which comes within subdivision* (4) *of section* 234 (*a*) *of the Revenue Act of* 1918. *It was not a worthless "debt" as comprehended by subdivision* (5) *of said section* 234 (*a*).

(2) *The loss was sustained during the taxable year* 1918.

## Argument

The writ of certiorari in this case was granted because petitioner represented, as is the fact, that it would be controlled by the decision of this court in the case of United States v. S. S. White Dental Company, then pending in the Supreme Court. As stated in said petition at page 2 thereof:

> "This case presents another phase of the same question involved in *United States v. S. S. White Dental Company*, No. 957, on the docket of this

> Court for the present term, in which, upon the request of the Government, a writ of certiorari was granted on April 19, 1926."

The White case was decided in favor of the taxpayer in an opinion handed down on May 16, 1927, and not as yet officially reported. This decision should, therefore, dispose, in favor of the taxpayer in the instant case, of all errors assigned with respect to the decision of the Circuit Court of Appeals below.

(1) *The transaction in question resulted in a "loss" which comes within subdivision* (4) *of section* 234 (*a*) *of the Revenue Act of* 1918. *It was not a worthless "debt" as comprehended by subdivision* (5) *of said section* 234 (*a*).

In the case of *United States v. S. S. White Dental Company*, supra, there was more reason for holding a part of the loss at issue a "debt" than in the instant case. There part of the loss was represented, as set out in the opinion of the Supreme Court, by "* * * an open account, due to respondent from the German company."

The Circuit Court of Appeals below, after discussing the distinction intended by Congress in differentiating in section 234 (a) of the Revenue Act of 1918 between a "loss" and a "debt", stated (R. 35-36):

> "Some definitions of 'loss' cover the transaction in question. The plaintiff failed to keep what it had and parted with it through fraud and misrepresentation. On the other hand, there are definitions of 'debt' which do not include this transaction.
>
> * * *
>
> "In the construction of a taxing statute doubts

should be resolved against the Government and in favor of the taxpayer. American Net & Twin Co. v. Worthington, 141 U. S. 468, 474; Benziger v. United States, 192 U. S. 38, 55; Gould v. Gould, 245 U. S. 151. It is not clear to us that the term 'losses' in subdivision (a) (4) of section 234 of the Act does not include the loss of $27,205.35. Therefore the judgment of the District Court is reversed and a new trial granted."

It is submitted that Congress used the terms "losses" and "debts" in their ordinary and accepted meaning in trade and business; that is, that "worthless", commonly referred to in trade circles as "bad" debts result from transactions originating in connection with sales, which are ordinarily recorded as accounts receivable. A bank sells money and its loans, if unpaid, constitute bad debts. A wholesaler or retailer of merchandise sells merchandise on credit, and these accounts are those subject to the bad debt charge off. The bad debt provision was intended to give credit grantors a wider latitude in annual deductions from taxable income than they would otherwise enjoy.

A loss to be deducted must be "sustained" in the taxable year. It cannot, by the exercise of any judgment on the part of the taxpayer, be shifted from one year to another. On the other hand, with respect to bad debts, a taxpayer was to be allowed to exercise, to a certain extent, his own judgment. To entitle him to charge off a bad debt, the transaction did not necessarily have to be closed. The account by its terms might not be due at the date of the charge off. Nor did he have to establish absolute uncollectibility. All that was needed was to show that, in the light of all the surrounding circumstances at the end of the taxable year, it was reason-

able to apprehend that the account could not be collected. This account might be paid in January of the succeeding year, but that fact would not affect the previous deduction.

The percentage of bad debts to the total of sales usually runs in a fixed percentage from year to year, and under the more recent revenue acts a reserve can be created to take care of bad debts. The average credit man of any business house if requested to state the percentage of bad debts for a given year, will give one based on a percentage of sales. He will not take into consideration as bad debts money paid out to purchase merchandise never delivered.

This is recognized in the brief for petitioner, because it is sought in the argument to separate the transaction in question into a purchase and the granting of credit.

> "* * * the contract for purchase and delivery of ore, was in fact treated by the parties as an independent transaction." (Brief, 8)

This is contrary to the facts, the trade acceptance itself having written in the body thereof "The obligation of the acceptor hereof arises out of the purchase of goods from the drawer," (R. 19) and the findings of fact state "* * * if said car was not shipped and delivered as agreed, the plaintiff was at liberty to refuse to pay the said trade acceptance." (R. 30)

The fact that the item was originally entered by the respondent on its books as an "account receivable" is not significant. Neither the trial court nor the Circuit Court of Appeals attached any importance to this entry. If there was a disputed set of facts to be considered, such an entry might be of some evidentiary value.

Where the facts are undisputed, it is of no importance whatsoever. Mere bookkeeping entries are not conclusive upon the Government, nor where the facts are undisputed, upon the taxpayer. This rule has been so often enunciated by this court that citation of the authorities is unnecessary.

An item must have been included in "income" to justify a charge off as a bad debt (Article 152, Regulations 45 and 62). A sale on credit (at an increase over cost) is the most common transaction, and it increases income in the year in which it is put on the books. Not so with losses, for with proper bookkeeping they do not create income. An embezzlement does not increase taxable income in the year the money is taken, and hence cannot be used as an offset to income in a later year when discovered. The deduction must go back to the year the loss was sustained. By this test the loss here at issue could never have been charged off as a bad debt.

In *Appeal of Cornelius Lumber Company*, Docket No. 4273, 5 B.T.A. 215, a transaction like the one here considered was held to be a "loss" as distinguished from a worthless debt. In that case taxpayer made advances against lumber as cut, which was to be held for future deliveries. When the lumber was shipped taxpayer was to deduct these advances from the invoice prices. The lumber company became insolvent and taxpayer found it was short 393,000 feet of lumber which it had reported as being ready for shipment and against which the taxpayer had made advances. Held, that the transaction resulted in a "loss" and that the loss was sustained in the year 1920, when the advances were made.

From the opinion of the Board (page 221):

"We are of the opinion that the taxpayer is entitled to a deduction for 1920 of $48,078.19 as a loss sustained within the year as a result of the advances made to the Sycamore Plantation Co. for lumber to be furnished by it. The taxpayer was not to be repaid the advances in money direct. Instead taxpayer was to receive lumber and, in making remittances to the Plantation Co., taxpayer, under the contract, deducted from the price at which the lumber was invoiced to it, among other sums, the amount of $30 or $35 a thousand feet, according to the grade of lumber. The contract between the parties provided that, in the event of failure of the Plantation Co. to fulfill its part of the contract, the taxpayer should take possession of all the lumber on hand and apply the same against the advances theretofore made. When the Plantation Co. became insolvent and ceased operations early in November, 1920, the taxpayer took possession of the lumber and found that it was of a value of $50,062.08. It therefore sustained a loss of $48,078.19, being the difference between the amount advanced against which the lumber was to be applied and the value of the lumber taken over."

The purpose of the Revenue Act of 1918 was to obtain for tax purposes a correct statement of net income for each year standing alone. To conclude that taxpayer's income for the year 1918 was correctly stated without giving it the benefit of this deduction is to completely disregard the real facts. To say to this taxpayer that its remedy is a charge-off in 1922, long after it had ceased to transact business and have any income, is so inequitable as to require every effort to prevent a strained construction of the Act which would perpetrate such injustice.

The construction given to Section 234-(a) (4) and (5) of the Revenue Act of 1918 by the trial court results in a distortion of the taxpayer's 1918 income. If in applying the law to the facts of this case there is any doubt as to the correct rule, then this brief may properly include a reference to the following case:

*Knowlton v. Moore*, 178 U. S. 41; 3 Am. F.T.R., 2684, 2698, (1900).

The issue there was with respect to death duties levied under the War Revenue Act of 1898.

Mr. Justice *White*:

> "We are therefore bound to give heed to the rule that, where a particular construction of a statute will occasion great inconvenience or produce inequality and injustice, that view is to be avoided if another and more reasonable interpretation is present in the statute."

(2) *The loss was sustained during the taxable year* 1918.

The argument of the petitioner that a loss is not sustained until the transaction is closed and completed is based upon an interpretation of the Act by the Treasury Department. The statute itself has but one requirement. The loss must have been "sustained" during the taxable year. A completed transaction within the taxable year may or may not be necessary to prove the loss was actually sustained. It frequently happens that the investigation made in a subsequent year discloses that the loss was actually "sustained" in the previous year.

Having grafted on to the Act by this interpretation a requirement not found therein, the Treasury Depart-

ment is too rigid in the enforcement of its interpretation, in that it requires that the taxpayer, seeking to charge off a loss as of any one year, conclusively demonstrate that as of December 31st of the year of the charge off there was no possibility whatsoever of ultimate recovery. It is this same engrafted, rigid interpretation of the Act that is relied upon in petitioner's brief in this case.

The case of *United States v. S. S. White Dental Company*, supra, sustains taxpayer's contention in this point. In this case the money was lost when it was paid out in 1918. Not one penny was ever recovered. In the Dental Company case there was always a possibility of recovery and in fact an ultimate recovery. The opinion of this court in that case fully covers the instant case. In fact, the petition for the writ of certiorari, as already pointed out, concedes that both cases are so alike as to make the decision in the one dispose of the other. In the White case, supra, this court said:

> "* * * The quoted regulations, consistently with the statute, contemplate that a loss may become complete enough for deduction without the taxpayer's establishing that there is no possibility of an eventual recoupment. It would require a high degree of optimism to discern in the seizure of enemy property by the German Government in 1918 more than a remote hope of ultimate salvage from the wreck of the war. The taxing Act does not require the taxpayer to be an incorrigible optimist."

Respectfully submitted,

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George R. Beneman,
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October 15, 1927.

FILED
APR 11 1927
WM. R. STANSBURY
CLERK

IN THE

# Supreme Court of the United States

Docket No. [redacted] 71
File No. 31960

C. G. LEWELLYN, Collector of Internal Revenue for the Twenty-third District of the United States,

*Petitioner,*

vs.

ELECTRIC REDUCTION COMPANY, a corporation,

*Respondent.*

## BRIEF OF AMICUS CURIAE.

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IN THE

# Supreme Court of the United States

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**Docket No. 394**

**File No. 31960**

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C. G. LEWELLYN, Collector of Internal Revenue for the Twenty-third District of the United States,
Petitioner,

vs.

ELECTRIC REDUCTION COMPANY, a corporation,
Respondent.

---

## BRIEF OF AMICUS CURIAE.

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This brief, filed with the consent of the Court first had and obtained, is submitted in the hope of assisting in elucidating certain statutory provisions affecting the above-entitled action. Counsel submitting this case represents a client in a matter involving the construction of the same statutory provisions.

These provisions are paragraphs (4) and (5) of subdivision (a) of Section 234 of the Revenue Act of 1918, reading as follows:

> "Section 234. (a) That in computing the net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions:
>
> (4) Losses sustained during the taxable year and not compensated for by insurance or otherwise;
>
> (5) Debts ascertained to be worthless and charged off within the taxable year."

In the instant case, it is contended that the transaction resulted in a loss, as distinguished from a worthless debt, and, in the writer's opinion, the facts justify that contention. It is his desire, however, to bring to the attention of the Court another phase of the situation.

The Treasury Department has from the beginning interpreted paragraphs (4) and (5) above quoted as separate and independent provisions, having no relation to each other. If a loss happens to fall in that class of losses in which the relationship of debtor and creditor exists, it cannot be deducted from gross income in the year in which the loss occurred unless the creditor ascertained it and charged it off his books within that year. Some courts have fallen into the same error; but, in justification, it may be said that, so far as we have been able to discover, the precise arguments now made have never before been presented in any court.

Paragraph (4) was clearly framed of necessity in order to eliminate from taxable net income a non-taxable return of capital. There could be no gain in a taxable period until losses sustained in attempting to make gain during that period were recouped.

Paragraph (5) was not, however, enacted under any such necessity, since paragraph (4) was broad enough to

cover the matter. Paragraph (5) was apparently an attempt at equalizing taxation, and was intended to benefit taxpayers and not to deprive them of rights which they would otherwise have had. The reason for its enactment was that because of the peculiar nature of losses resulting from debts becoming worthless it was recognized that it might frequently be impossible to determine in just what year such losses were sustained. In such cases, the taxpayer might not be able to bring its case within paragraph (4) and the benefit of Section 234 might be lost to it altogether, because of its inability to establish in what year it actually sustained the loss. Paragraph (4) is restricted to "losses sustained within the year."

In order to prevent this possible injustice, paragraph (5) was inserted to permit, as alternative relief, the deduction of worthless debts for the year in which the worthlessness was ascertained. It is obvious, therefore, that this provision was intended to be entirely beneficial to taxpayers. It was intended, not to lay down a hard and fast rule as to this class of losses, as distinguished from other losses sustained, but to enable taxpayers to establish their right to deductions for such losses in cases where it would have been impossible to prove in what year the loss was actually sustained. While it might be impossible to determine in what year a debt became worthless and therefore a loss, it would not be difficult for the taxpayer to show in what year it ascertained it to be worthless.

This remedial, salutary and beneficial legislation should not be so construed and applied as to cause it to work a hardship upon the persons it was intended to benefit. Yet that is what has been done by the Treasury Department. In many cases taxpayers have not known during the taxable year that debts became worthless, but have subsequently found out the exact time. In such cases the Treasury Department has allowed the deduction for the

year in which the loss was ascertained and has refused to allow it for the year in which it was actually sustained. This has often thrown the deduction into a year in which the taxpayer had no income, or in which the income tax rates were lower than in the year when the loss was sustained. The instant case is an excellent example of the injustice resulting from such administration of paragraph (5). In this case the time when the loss was sustained was definitely determined. There was therefore no reason for the application of paragraph (5), whether or not the loss arose from the relationship of debtor and creditor. This was not one of the cases for which paragraph (5) was intended to afford relief. Here it works a hardship, as administered, since it places the deduction in a year when there was not sufficient income to absorb it, and there was no excess profits tax, although the loss was sustained in a year when there was a very high excess profits tax.

A loss may be sustained in one year but not discovered until a later year. This does not render it not deductible for the year in which sustained, for the reason that in determining correct taxable income the true facts should govern, and not only those of which the taxpayer has knowledge during the year. Adjustments and corrections may be made in subsequent years, and Congress has recognized the necessity for this by providing that deficiencies may be assessed, and refunds of overpayments made within five years after the return was filed, or for longer periods under certain conditions prescribed by law. It has also provided that suits may be brought to recover overpayments of taxes without the necessity of alleging payment under protest or duress. Discovery after the expiration of a taxable year of facts pertinent to the determination of the income and profits taxes for that year may be given effect by filing an amended return. The necessity for such corrections is recognized and the procedure prescribed in

Article 111 of Regulations 45 and the corresponding article of Regulations 62 of the Bureau of Internal Revenue. A portion of the latter reads as follows:

> "If subsequently to its occurrence, however, a taxpayer first ascertains the amount of a loss sustained during a prior taxable year which has not been deducted from gross income, he may render an amended return for such preceding taxable year including such amount of loss in the deductions from gross income and may file a claim for refund of the excess tax paid by reason of the failure to deduct such loss in the original return. A loss from theft or embezzlement occurring in one year and discovered in another is ordinarily deductible for the year in which sustained."

So that if, during the period within which adjustments may be made, the taxpayer discovers that a loss was sustained in a prior year, he is permitted to correct his return for that year and take the loss. There is no reason why the same procedure should not be followed with respect to worthless debts, provided the year in which they become worthless can be established.

There are many cases in which facts are subsequently ascertained which definitely show that debts became worthless in prior years. For example, a debtor may become insolvent but the taxpayer creditor has a lien on certain property which, as far as it knows, is adequate security. It may later discover that this property was at that time subject to a prior lien, as, for instance, a debt or taxes due the Government, which left no assets for distribution to the creditor taxpayer. Here the loss was definitely sustained, because of the prior lien, say, in 1918, when the tax was at the rate of 82.4%. In 1922, when the tax was 12½%, taxpayer first ascertains that its security was subject to such prior lien, and that its debt was worthless in 1918. Under present administration

of the tax laws, this taxpayer is not heard to say that the loss was sustained in 1918 and the deduction applicable to that year; it is required to take the deduction in 1922, provided it charged the amount off its books in 1922. It paid tax on receipts which merely replaced its lost capital in 1918, at 82.4%; it abates its tax on the same amount, in 1922, but only at 12½%. The net result is that it has paid a tax on a recoupment of capital, before any gain was derived, at 69.9%. The tax statute was obviously not intended to produce this result.

This, however, is not the only unjust and illegal effect of the Treasury Department's interpretation of this part of the law. By applying what it considers a strict and literal construction of the language of paragraph (5), it requires as conditions for the deduction of a worthless debt, first, that it be ascertained to be worthless within the taxable year, and second, that it be charged off within the taxable year. Thus, if a taxpayer, using its best judgment, but without adequate evidence, charges a debt off in one year, but cannot prove definitely that it ascertained it to be worthless in that year, it can never have the benefit of the deduction for any year, even though it can absolutely establish when the loss was actually sustained. Conversely, if a taxpayer ascertains a debt to be worthless in one year and charges it off in a later year, it can have no deduction for any year. It is hard to believe that the law was intended to operate in this way. The year when the capital loss was recovered is ignored entirely, income is created by bookkeeping entries, and a self-serving declaration by a taxpayer is made necessary evidence in his favor by this construction.

A more sensible construction is that paragraph (4) governs in every case; but where its conditions cannot be complied with, because of lack of evidence as to when the loss was actually sustained, the taxpayer is given another

chance. It can prove when it ascertained the loss, and deduct it for that year. The provision regarding charging off is for administrative purposes, to prevent allowance of the same deduction twice. As such it is a condition which may be performed retroactively, in compliance with the statutory requirement. It is not evidentiary, except as it may apply against, rather than in favor of, the taxpayer. Its proper use is as a disserving, rather than as a self-serving, declaration. And if the charge-off is made in the wrong year, the error should be subject to correction without invalidating taxpayer's deduction. It is submitted that this is a fair and reasonable construction of the statute, within the language used, even if strictly construed, and does substantial justice, while the construction urged by the Government is absurd, harsh, unjust, unnecessary, and not warranted by the language of the statute.

Respectfully submitted,

DONALD HORNE,
*Amicus Curiae.*

# SUPREME COURT OF THE UNITED STATES.

No. 71.—October Term, 1927.

C. G. Lewellyn, Collector of Internal Revenue for the Twenty-third District of the United States, etc., Petitioner,

*vs.*

Electric Reduction Company.

On Writ of Certiorari to the United States Circuit Court of Appeals for the Third District.

[November 21, 1927.]

Mr. Justice Stone delivered the opinion of the Court.

This case is here on writ of certiorari to the Circuit Court of Appeals for the third circuit, to review its judgment [11 Fed. (2d) 493] reversing the judgment of the district court for western Pennsylvania [8 Fed. (2d) 91], and awarding a new trial. The action was brought by respondent to recover income taxes paid by it for the year 1918. By written stipulation a jury was waived and the case was tried to the court, which made special findings and on them gave judgment for defendant. The principal question to be determined is the right of the respondent, upheld below, to deduct an admitted business loss from its gross income for 1918 in determining its tax for that year, rather than from gross income for a later year.

In July, 1918, respondent contracted with one Jouravleff for the sale and delivery to it in monthly installments of a quantity of tungsten ore. The contract required the buyer immediately to accept a bill of exchange drawn on him by the seller in the sum of $30,000, which was to be applied against the purchase price of the first carload of ore shipped. Respondent accepted the draft and the seller negotiated it through bankers associated with him in the transaction. Respondent paid it at maturity, in advance of any actual shipment of ore, having received from the broker who

had negotiated the sale, a telegram saying: "Shipment one car will be made today." Only a small quantity of ore was ever shipped. This was received in the following December and after being credited upon the amount of the draft left a balance of more than $27,000. In March of the following year respondent began three separate suits to recover the $27,000—one against the seller, the second against the broker as an alleged surety or guarantor of the seller, and the third against the bankers. Judgment secured against the seller in 1919 remains unsatisfied. The suit against the broker resulted in a judgment for the defendant in November, 1922. The suit against the bankers was discontinued in 1921 as useless after they had been adjudged bankrupt. Respondent did not charge off the $27,000 on its books in 1918, but continued to carry it as an item in its "bills receivable" account. It claimed no loss on account of the payment in its tax return for that year. Upon the termination of the litigation in 1922 it filed an amended tax return for 1918, deducting the uncollected balance as a loss, and brought the present suit to recover the alleged overpayment of tax.

Section 234 of the Revenue Act of 1918, c. 18, 40 Stat. 1057, 1078, provides that in arriving at taxable income there may be deducted:

"(4) Losses sustained during the taxable year and not compensated for by insurance or otherwise;

"(5) Debts ascertained to be worthless and charged off within the taxable year."

The district court held that the loss was upon a worthless debt deductible under subdivision (5) and not deductible for 1918 because not charged off in that year.

The respondent contends and the court below held that the loss was not one upon a worthless debt, deductible under sub-section (5), but was deductible when "sustained" under sub-section (4), and concludes that the loss was rightly deducted as of 1918 since the loss was sustained when respondent paid out the money for which it received no return.

We assume without deciding, as was assumed by both courts below, that sub-section (4) and sub-section (5) are mutually exclusive so that a loss deductible under one may not be deducted under the other. We may assume also that upon the abandonment of the con-

tract by the seller the buyer might have maintained an action to recover the balance of the money which he had paid. But so far as appears from the record there had been no abandonment by the seller in 1918. Throughout that period the buyer was calling for deliveries and some were made as late as in December. The buyer's rights were upon a contract for the delivery of merchandise and were not a "debt" in either a technical or a colloquial sense. We conclude that if respondent's contract rights became worthless in 1918 he was not required to deduct his loss as a worthless debt under sub-section (5), but was entitled to deduct it under subsection (4) as a loss sustained in that year.

But we do not think that a loss resulting from a buyer's prepayment to a seller who proves to be irresponsible is necessarily sustained, in the statutory meaning, as soon as the money is paid. The statute was intended to apply not only to losses resulting from the physical destruction of articles of value but to those occurring in the operations of trade and business, where the business man has ventured on a course of action in the reasonable expectation that the promised conduct of another will come to pass. Not only the future success of the business but its present solvency depends on the probable accuracy of his prophecy. Only when events prove the prophecy to have been false can it be said that he has suffered. His case is not like that of a man who fails to learn of the theft of his bonds or the burning of his house until a year after the occurrence; but rather resembles the position of a merchant who buys in one year, for sale in the next, merchandise which shifting fashion renders unsaleable in the latter. It may well be that he whose house has been burned has sustained a loss whether he knows it or not and may recover a tax paid in ignorance of that material fact. But we cannot say that the merchant whose action has been based not merely on ignorance of a fact but on faith in a prophecy —even though the prophecy is made without full knowledge of the facts—can claim to have sustained a loss before the future fails to justify his hopes.

Here the only fact relied upon to show a loss is the outcome of the litigations two years after respondent's payment to Jouravleff. There is nothing in the findings from which we could conclude that the respondent in 1918 had ceased to regard his rights under the contract as having value or that there was then reason-

able ground to suppose that efforts to enforce them would be fruitless. On the findings respondent is not entitled to recover.

At the trial respondent offered evidence that it had conducted, in 1918, an investigation which tended to show the irresponsibility of Jouravleff. Inquiries, variously phrased, to elicit this fact were excluded by the trial judge both because they were irrelevant and because the evidence offered was inadmissible as hearsay. An examination of the bill of exceptions discloses that the proffered testimony was rightly excluded on this latter ground. Hence no error was committed by the trial court in its rulings. A trial by jury having been waived in writing, our review in this case is limited to the sufficiency of the facts specially found to support the judgment, and to the rulings excepted to and presented by the bill of exceptions, Rev. Stat. §§ 649, 700; *Fleischmann Co.* v. *United States*, 270 U. S. 349, and we are without power to grant a new trial except for error thus presented. *Mueller Grain Co.* v. *American State Bank*, No. 61, October Term, 1927, decided October 24, 1927, reversing 15 Fed. (2d) 899. The judgment of the district court was right, for reasons other than those assigned by it. It is affirmed, and the judgment of the court of appeals is

*Reversed.*

A true copy.

Test:

*Clerk, Supreme Court, U. S.*